S. HRG. 100–426

LEGISLATIVE PROPOSALS TO RESTRUCTURE OUR FINANCIAL SYSTEM

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

S. 1886

TO MODERNIZE AND REFORM THE REGULATION OF FINANCIAL SERVICES, AND FOR OTHER PURPOSES

S. 1891

TO ESTABLISH A FINANCIAL SERVICES OVERSIGHT COMMISSION, AND FOR OTHER PURPOSES

S. 1905

TO ENHANCE COMPETITION IN THE FINANCIAL SERVICES SECTOR, AND FOR OTHER PURPOSES

DECEMBER 1, 2, 3, 8, 9, and 10, 1987

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LEGISLATIVE PROPOSALS TO RESTRUCTURE OUR FINANCIAL SYSTEM

TUESDAY, DECEMBER 1, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m. in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Sarbanes, Dixon, Sasser, Sanford, Shelby, Graham, Wirth, Garn, Heinz, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

With the expiration of the moratorium 3 months away, the Congress has its work cut out. The committee is moving forward with the legislation to meet that deadline.

Some have suggested that the recent turbulence in the stock market is sufficient reason to delay or to forego altogether the repeal of the barrier between investment banking and commercial banking known as the Glass-Steagall Act. I disagree.

The time to pass new constructive financial legislation is now and for two reasons. First, Glass-Steagall has been shattered. The barrier between commercial banking and investment banking has been perforated in both directions. Whatever protection Glass-Steagall allegedly provided has long since ceased to be effective. What remains is only the protectionist barrier to socially beneficial competition.

Commercial banks already underwrite corporate securities. They do it through their offshore subsidiaries. It makes no sense to permit them to underwrite bonds and equities in the Euromarkets but not at home. And investment banks have taken over the traditional bread and butter market of commercial banks. What was once a commercial loan is now commercial paper.

The banks cannot adapt to the new techniques of securitization so they must stand by and watch in their 1933 model straitjacket.

The second reason for passing legislation now is to reassert congressional control over the shape of our financial system. Failing to pass legislation does not mean that restructuring will cease after March 1. The question is not whether our financial system should be restructured. Eventually it will be whether or not we act.

The question is how that restructuring is to occur and under what kind of regulatory framework. The inability of the two houses of Congress to act will delegate to the regulators, the courts, and the loophole lawyers the responsibility for the design of our financial landscape.

Bank safety and soundness is of concern to us all. The best way to enhance safety and soundness is to pass legislation that acknowledges the reality of the financial system of the 1980's while at the same time providing specific safeguards to preserve safety, prevent conflicts of interest, and enhance competition.

This morning we are fortunate to have Federal Reserve Chairman Alan Greenspan before the committee to testify on the need for modernization of our financial structure. At some later time, the Chairman will come before the committee to discuss Federal Reserve Board policy with respect to the stock market. It's my understanding that it would not be helpful to Federal Reserve policy with respect to our country's economic welfare for committee members to insist on answers to questions in that area this morning. That's not the purpose of the hearing. I hope that members will confine their questions to the Glass-Steagall Act which is certainly a very full plate and it should fully involve our attention and our time at this hearing.

Chairman Greenspan, I want to thank you for appearing before us today to discuss this urgent legislative matter. I hope that in your remarks you will give considerable attention to the two bills that have been introduced by members of this committee; S. 1886 by Senator Garn and myself; and S. 1891 by Senators Graham and Wirth.

[Copies of proposed bills follow:]

II

100TH CONGRESS
1ST SESSION

S. 1886

To modernize and reform the regulation of financial services, and for other purposes.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 20 (legislative day, NOVEMBER 19), 1987

Mr. PROXMIRE (for himself and Mr. GARN) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To modernize and reform the regulation of financial services, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Financial Modernization Act of 1987".

(b) TABLE OF CONTENTS.—

TITLE I—SECURITIES AFFILIATES OF BANK HOLDING COMPANIES

Sec. 101. Amendments to the Banking Act of 1933.
Sec. 102. Authorization for bank holding companies to acquire securities affiliates.
Sec. 103. Definition of securities affiliate.
Sec. 104. Ninety-one day rule for securities affiliate applications.
Sec. 105. Effect on State laws prohibiting the affiliation of banks and securities companies.

Sec. 106. Amendment to the Federal Reserve Act.
Sec. 107. Securities affiliations of FDIC-insured banks.
Sec. 108. Authorization for national banks to underwrite municipal revenue bonds, sponsor unit investment trusts, and distribute investment company securities.

TITLE II—EXPEDITED PROCEDURES

Sec. 201. Expedited procedures for forming a bank holding company.
Sec. 202. Exemption of certain bank holding company formations from registration under the Securities Act of 1933.
Sec. 203. Expedited procedures for bank holding companies to seek approval to engage in nonbanking activities.
Sec. 204. Reduction of post-approval waiting period for bank holding company acquisitions.
Sec. 205. Reduction of post-approval waiting period for bank mergers.

TITLE I—SECURITIES AFFILIATES OF BANK HOLDING COMPANIES

SEC. 101. AMENDMENTS TO THE BANKING ACT OF 1933.

Section 20 (12 U.S.C. 377) and section 32 (12 U.S.C. 78) of the Banking Act of 1933 are repealed.

SEC. 102. AUTHORIZATION FOR BANK HOLDING COMPANIES TO ACQUIRE SECURITIES AFFILIATES.

Section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) is amended by adding at the end thereof the following new paragraph:

"(15)(A) SECURITIES AFFILIATES.—shares of a securities affiliate which may, in accordance with this paragraph—

"(i) engage in underwriting, distributing, or dealing in securities of any type;

"(ii) engage in securities brokerage, investment advisory, private placement, or other securities activities permitted for brokers or dealers registered under the Securities Exchange Act of 1934 or for investment advisers registered under the Investment Advisers Act of 1940; and

"(iii) engage in, or acquire the shares of a company engaged in, any activity that is not described in clause (i) or (ii) of this subparagraph, if another provision of this section permits a bank holding company or subsidiary thereof to engage in that activity or acquire those shares, and—

"(I) the Board permits the bank holding company to engage in that activity or acquire those shares through the securities affiliate, or

"(II) that provision permits the bank holding company or a subsidiary thereof to engage in that activity or acquire those shares without the Board's approval.

"(B) APPLICATION REQUIREMENTS.—

"(i) The following provisions shall apply during the 2 years following the date of enactment of the Financial Modernization Act of 1987:

"(I) A bank holding company shall not acquire shares of a securities affiliate pursuant to this paragraph without the Board's prior approval.

"(II) In acting on an application under this paragraph, the Board shall apply the criteria specified in this subparagraph and in paragraph (8)(B)(iv) of this subsection.

"(III) The Board shall not approve an application under this paragraph unless the Board is satisfied that the bank holding company possesses the managerial resources to conduct the securities activities safely and soundly. In making that determination, the Board shall take into account the experience of management and its record of successfully managing the bank holding company or enterprises engaged in activities that are the same as or similar to those authorized for securities affiliates under this paragraph.

"(ii) Beginning 2 years after the date of enactment of the Financial Modernization Act of 1987, a bank holding company seeking to acquire shares pursuant to this paragraph shall comply with paragraph (8)(B) of this subsection. In making a determination under that paragraph, the Board shall apply the criteria specified in clause (iv) of that paragraph.

"(C) CONCENTRATION OF RESOURCES.—

"(i) The Board shall not approve any acquisition pursuant to this paragraph that would result in the affiliation of—

"(I) a bank holding company or bank that has, or had on average during any of the 8 calendar quarters preceding the date of the application, total assets of more than $30,000,000,000, with

"(II) an investment banking organization that has, or had on average during any of the 8 calendar quarters preceding the date of the application, total assets of more than $15,000,000,000.

"(ii) The dollar limitations in clause (i) of this subparagraph shall be adjusted annually after December 31, 1988, by the annual percentage increase in the Consumer Price Index as described in paragraph (8)(C) of this subsection.

"(D) FUNDING OF A SECURITIES AFFILIATE.—

"(i) A bank holding company shall not acquire control of a securities affiliate pursuant to this paragraph if that acquisition would reduce the bank holding company's capital below the minimum levels established by the Board for bank holding companies.

"(ii) A bank holding company shall not directly or indirectly make any additional equity investment in a securities affiliate that it has acquired control of pursuant to this paragraph unless it gives the Board prior written notice of the investment and—

"(I) the Board issues a written statement of its intent not to disapprove the notice; or

"(II) the Board does not disapprove the notice within 30 days after the notice is filed.

"(iii) The Board may disapprove a notice filed under clause (ii) if the Board finds that the investment would reduce the bank holding company's capital below the minimum levels established by the Board or would otherwise be unsafe or unsound or inconsistent with the bank holding company's obligation to serve as a source of strength to its subsidiary banks.

"(E) CAPITAL ADEQUACY.—(i) In determining whether a bank holding company complies with the capital requirements or guidelines established by the Board for bank holding companies—

"(I) the assets and liabilities of the securities affiliate shall not be consolidated with those of the bank holding company,

"(II) the bank holding company's equity investment in and extensions of credit to any securities affiliate shall be excluded, and

"(III) the bank holding company's total liabilities shall be reduced by an amount equal to the amount of the bank holding company's extensions of credit to any securities affiliate.

"(ii) Clause (i) of this subparagraph does not apply to the extent that the Board determines by order that an item described in that clause relates to activities that are not described in clause (i) or (ii) of subparagraph (A) of this paragraph.

"(F) LIMITATIONS ON SECURITIES AFFILIATES AND THEIR AFFILIATES.—

"(i) No bank or insured institution affiliated with a securities affiliate shall, directly or indirectly—

"(I) extend credit in any manner to the securities affiliate or a subsidiary thereof,

"(II) purchase for its own account assets of the securities affiliate or a subsidiary thereof, "(III) issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the securities affiliate or a subsidiary thereof, or

"(IV) extend credit in any manner to any investment company advised by or the shares of which are distributed by the securities affiliate.

"(ii) Subclauses (I) and (II) of clause (i) do not apply to any extension of credit by a bank or insured institution made to acquire or sell any securities of the United States or its agencies or securities on which the principal and interest are fully guaranteed by the United States or its agencies if—

"(I) the extension of credit is to be repaid on the same calendar day,

"(II) the extension of credit is incidental to the clearing of transactions in those securities through that bank or insured institution, and

"(III) both the principal of and the interest on the extension of credit are fully secured by securities of the United States or its agencies or securities on which the principal and interest are fully guaranteed by the United States or its agencies.

"(iii) No bank or insured institution affiliated with a securities affiliate shall directly or indirectly extend credit, or issue or enter into a standby letter of credit, asset purchase agreement, indemnity, guarantee, insurance, or other facility, for the purpose of enhancing the marketability of a securities issue underwritten or distributed by the securities affiliate.

"(iv) No bank holding company or subsidiary thereof (other than a securities affiliate) shall knowingly extend or arrange for the extension of credit, directly or indirectly, secured by or for the purpose of purchasing any security while, or for 30 days after, that security is the subject of a distribution in which a securities affiliate of that bank holding company participates as an underwriter or a member of a selling group.

"(v) No bank or insured institution affiliated with a securities affiliate shall, directly or indirectly, extend credit to an issuer of securities underwritten by the securities affiliate for the purpose of paying the principal of those securities or interest or dividends on those securities. Nothing in this clause prohibits an extension of credit for a documented purpose (other than paying principal, interest, or dividends) if the timing, terms, conditions, and maturity of the credit are substantially different from those of the securities being underwritten.

"(vi)(I) No officer or director of a securities affiliate shall serve at the same time as an officer or director of any affiliated bank or insured institution.

"(II) Notwithstanding subclause (I) of this clause, an officer or director of a securities affiliate may serve at the same time as an officer or director of an affiliated bank or insured institution if the securities affiliate and the affiliated bank or insured institution are subsidiaries of a bank holding company that has total banking assets of not more than $500,000,000.

"(III) The dollar limitation in subclause (II) of this clause shall be adjusted annually after December 31, 1988, by the annual percentage increase in the Consumer Price Index as described in paragraph (8)(C) of this section.

"(IV) The Board may, by order or by regulation, grant exemptions from subclause (I) of this clause. In determining whether to grant such exemptions, the Board shall consider the size of the bank holding companies, banks, and securities affiliates involved, any burdens that may be imposed by subclause (I), the safety and soundness of the banks and securities affiliates, and other appropriate factors.

"(vii) Pursuant to regulations issued by the Securities and Exchange Commission, a securities affiliate shall prominently disclose in writing to each of its customers—

"(I) that the securities affiliate is not a bank or insured institution and is separate from any affiliated bank or insured institution; and

"(II) that securities sold, offered, or recommended by the securities affiliate are not deposits, are not insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, are not guaranteed by an affiliated bank or insured institution, and are not otherwise an obligation of such a bank or insured institution.

"(viii) No bank, insured institution, or subsidiary thereof shall express an opinion on the value of, or the advisability of purchasing or selling, securities underwritten, dealt in, or distributed by its securities affiliate unless the bank, insured institution, or subsidiary discloses to the customer that the securities affiliate is underwriting, dealing in, or distributing the securities.

"(ix) No bank, insured institution, or subsidiary thereof shall disclose to its securities affiliate, nor shall a securities affiliate disclose to an affiliated bank, insured institution, or subsidiary thereof, any nonpublic customer information (including an evaluation of the creditworthiness of an issuer or other customer of that bank, insured institution, subsidiary, or securities affiliate) without the consent of that customer.

"(x) A securities affiliate shall not underwrite or distribute securities secured by or representing an interest in mortgages or other obligations originated by an affiliated bank, insured institution, or subsidiary thereof unless those securities are rated by an unaffiliated, nationally recognized statistical rating organization.

"(xi) Each appropriate Federal banking agency shall establish a program for—

"(I) enforcing compliance with the requirements of this paragraph on the part of banks or insured institutions under its supervision; and

"(II) responding to any complaints from customers about inappropriate cross-marketing of securities products or inadequate disclosure.

"(xii) Nothing in this paragraph limits—

"(I) any authority of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, or the Securities and Exchange Commission; or

"(II) any disclosure or registration requirements under the securities laws (as defined in section 21(g) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(g)).

"(G) SECURITIES AFFILIATES APPROVED UNDER PARAGRAPH (8).—

"(i) No bank holding company may engage in, or retain the shares of any company engaged in, activities of the type described in clause (i) of subparagraph (A) of this paragraph on the basis of the Board's approval of an application under paragraph (8) of this subsection—

"(I) unless the bank holding company obtains the Board's approval to retain the shares of that company pursuant to this paragraph; or

"(II) except to the extent that those activities are specifically authorized by statute for a national bank and involve securities that are expressly described in that statute, or that a regulation promulgated by the Comptroller of the Currency pursuant to that statute before November 18, 1987, expressly describes as being authorized for a national bank to underwrite or deal in.

"(ii) The Board shall, after the date of enactment of this paragraph, disapprove any notice by a bank holding company under paragraph (8) of this subsection to engage in, or acquire the shares of a company engaged in, any activity that is described in clause (i) of subparagraph (A), except to the extent that the activity is described in subclause (II) of clause (i) of this subparagraph.

"(H) ACTIVITIES PERMITTED FOR BANK AFFILIATES.—A bank holding company that acquires control of a securities affiliate under this paragraph shall not, after one year from the date of that acquisition, permit a bank or insured institution that it controls or any subsidiary thereof to engage, directly or indirectly, in the United States—

"(i) in activities described in clause (i) of subparagraph (A) (except to the extent that those activities are described in subclause (II) of clause (i) of subparagraph (G)); or

"(ii) in underwriting or distributing securities backed by or representing an interest in mortgages or other obligations originated or purchased by the bank or its affiliates.

"(I) WAIVER OF EXAMINATION AND CAPITAL REQUIREMENTS.—

"(i) A bank holding company that controls a securities affiliate pursuant to this paragraph, and any subsidiary (other than a bank) of that bank holding company, shall not be subject to inspection or examination or to reporting or capital requirements established by the Board under this Act or the International Lending Supervisory Act of 1983, if—

"(I) on average during the preceding calendar year, 80 percent or more of the bank holding company's consolidated revenues were derived from securities activities and 80 percent or more of the bank holding company's consolidated assets were devoted to securities activities; and

"(II) the bank holding company maintains the capital of each of its subsidiary banks or insured institutions at or above the levels established for that bank or insured institution by the appropriate Federal banking agency.

"(ii) Notwithstanding clause (i), the Board may examine or require reports of a bank holding company that qualifies under clause (i), and any nonbank subsidiary thereof, in order to—

"(I) determine whether the bank holding company qualifies under clause (i);

"(II) assure compliance by the bank holding company or nonbank subsidiary with the provisions of this Act, the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972), and sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1); or

"(III) assure that the safety and soundness of the bank holding company's subsidiary banks are not threatened by the activities or condition of the bank holding company or its nonbank subsidiaries whenever the Board determines that emergency conditions exist requiring such assurance.

"(iii)(I) If a bank holding company that has claimed qualification under clause (i) fails to maintain the capital of each of its subsidiary banks at or above the level established for that bank by the appropriate Federal banking agency, the Board shall advise the bank holding company of the capital deficiency and provide the bank holding company 30 days in which to restore the capital of that bank to the level required by the appropriate Federal banking agency.

"(II) If the Board determines that the bank holding company is unable to restore the capital of its subsidiary bank to the required level, the Board may issue an order requiring the holding company to terminate its ownership or control of the bank within 180 days of the date of the order.

"(iv) For purposes of this subparagraph, the term 'securities activities' means underwriting, dealing in, distributing, or selling securities, securities brokerage activities, investment advisory activities, and such other investment banking activities as the Board determines should be classified as securities activities or as activities incidental thereto.

"(J) Definitions.—For purposes of this paragraph—

"(i) a branch or agency of a foreign bank or a commercial lending company controlled by a foreign bank (as the terms 'agency', 'branch', 'commercial lending company', and 'foreign bank' are defined in section 1 of the International Banking Act of 1978 (12 U.S.C. 3101)), shall be considered a bank;

"(ii) the term 'appropriate Federal banking agency' means the agencies referred to in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)) with respect to banks referred to in that section and the Federal Home Loan Bank Board (acting directly or through the Federal Savings and Loan Insurance Corporation) with respect to insured institutions; and "(iii) the terms 'deal in' and 'dealing in' do not include purchasing or selling securities for the account of another person.".

SEC. 163. DEFINITION OF SECURITIES AFFILIATE.

Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) is amended by adding at the end thereof the following new subsection:

"(n) SECURITIES AFFILIATE.—

"(1) The term 'securities affiliate' means any company that—

"(A) is engaged in the United States pursuant to section 4(c)(15)(A) of this Act in one or more of the activities described in clause (i) of that subparagraph; and

"(B) is registered as a broker or dealer under the Securities Exchange Act of 1934.

"(2) A company is described in paragraph (1) only so long as it is owned or controlled by a bank holding company.".

SEC. 164. NINETY-ONE DAY RULE FOR SECURITIES AFFILIATE APPLICATIONS.

(a) NINETY-ONE DAY RULE.—Section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) is amended by striking out "paragraph (8)" in the penultimate sentence and inserting in lieu thereof "paragraph (15)".

"(b) Sunset Provision.—The penultimate sentence of section 4(c) of the Bank Holding Company Act of 1956 (as amended by this Act) is repealed, effective 2 years after the date of enactment of this Act.".

SEC. 105. EFFECT ON STATE LAWS PROHIBITING THE AFFILIATION OF BANKS AND SECURITIES COMPANIES.

Section 7 of the Bank Holding Company Act of 1956 (12 U.S.C. 1846) is amended by inserting before the final period the following: ", except that no State may prohibit a bank or bank holding company from being affiliated with a securities affiliate solely because the securities affiliate is engaged, pursuant to clause (i) of section 4(c)(15)(A) of this Act, in activities described in that clause".

SEC. 106. AMENDMENT TO THE FEDERAL RESERVE ACT.

Section 23B(b)(1)(B) of the Federal Reserve Act (12 U.S.C. 371c–1(b)(1)(B)) is amended by inserting "and for 30 days thereafter" after "during the existence of any underwriting or selling syndicate".

SEC. 107. SECURITIES AFFILIATIONS OF FDIC-INSURED BANKS.

(a) Securities Affiliations.—Section 18(j)(3) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)(3)) is amended to read as follows:

"(3) Securities affiliations.—

"(A) GENERAL RULE.—Except as provided in section 4(c)(15) of the Bank Holding Company Act of 1956, an insured bank shall not be an affiliate of any company that directly or indirectly acts in the United States as an underwriter or dealer of any security, other than a security that a national bank is specifically authorized by statute to underwrite or deal in and—

"(i) that is expressly described in that statute; or

"(ii) that a regulation promulgated by the Comptroller of the Currency pursuant to that statute before November 18, 1987, expressly describes as being authorized for a national bank to underwrite or deal in.

"(B) EXCEPTIONS.—This paragraph does not apply to—

"(i) an insured bank that is described in subparagraph (D), (F), or (I) of section 2(c)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)(2)); or

"(ii) a foreign bank, as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)), solely because it has an insured branch in the United States.

"(C) GRANDFATHER PROVISION.—This paragraph does not prohibit the continuation of an affiliation that existed on March 5, 1987.

"(D) TRANSITION RULE.—An affiliation that became unlawful as a result of the enactment of the Competitive Equality Amendments of 1987, or that becomes unlawful as a result of the enactment of the Financial Modernization Act of 1987, may continue until August 10, 1989.

"(E) ACTIVITIES CONDUCTED DIRECTLY BY INSURED BANK.—Nothing in this paragraph restricts an activity that is conducted directly by an insured bank and is subject to section 21 of the Banking Act of 1933 (12 U.S.C. 378).

"(F) DEFINITIONS.—As used in this paragraph—

"(i) The term 'affiliate' has the meaning given to that term in section 2(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(k)).

"(ii) The term 'company' has the meaning given to that term in section 2(b) of the

Bank Holding Company Act of 1956 (12 U.S.C. 1841(b)).

"(iii) The term 'dealer' has the meaning given to that term in section 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(5)).

"(iv) The term 'security' has the meaning given to that term in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)).

"(v) The term 'underwriter' has the meaning given to that term in section 2(11) of the Securities Act of 1933 (15 U.S.C. 77b(11)).".

(b) CONFORMING AMENDMENTS.—Clause (i) of section 408(m)(1)(A) of the National Housing Act (12 U.S.C. 1730a(m)(1)(A)) is amended by inserting after "clause (iii) of this subparagraph," the following: "and in section 18(j)(3) of the Federal Deposit Insurance Act,".

SEC. 106. AUTHORIZATION FOR NATIONAL BANKS TO UNDERWRITE MUNICIPAL REVENUE BONDS, SPONSOR UNIT INVESTMENT TRUSTS, AND DISTRIBUTE INVESTMENT COMPANY SECURITIES.

(a) AUTHORIZATION.—Paragraph Seventh of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24) is amended by adding at the end thereof the following:

"The limitations and restrictions contained in this paragraph as to dealing in, underwriting, and purchasing for its own account, investment securities shall not apply to obligations issued or guaranteed by or on behalf of a State or any political subdivision thereof or any agency or instrumentality of either of the foregoing, except industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1986 (other than industrial development bonds on which the interest is exempt from Federal income tax under section 103(a) of the Internal Revenue Code of 1986), if (i) a State, territory, or possession of the United States, any political subdivision of the foregoing, or the District of Columbia pledges its full faith and credit for the payment of all principal and interest on such bonds or (ii) the issuer, or the State or local governmental unit on behalf of which the industrial development bonds were issued, is considered the sole owner, for Federal income tax purposes, of the facility with respect to which financing is to be provided from the proceeds of such industrial development bonds. If the association is not an affiliate of a securities affiliate (as the terms 'affiliate' and 'securities affiliate' are defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)), the limitations and restrictions contained in this paragraph as to dealing in, underwriting, and purchasing for its own account, investment securities shall not apply to (1) the securities of unit investment trusts (as defined in section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a–4(2)) holding only securities that the association is specifically authorized by statute to underwrite and that are expressly described in that statute, or expressly described as being authorized for a national bank to underwrite in a regulation promulgated by the Comptroller of the Currency pursuant to that statute before November 18, 1987, and (2) the distribution of securities issued by investment companies (as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3)) that are not organized, sponsored, managed, or controlled by the association or any affiliate of the association.".

(b) TECHNICAL AMENDMENT.—The sixth sentence of paragraph Seventh of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24) is amended by striking out "or general obligations of any State or of any political subdivision thereof,".

TITLE II—EXPEDITED PROCEDURES

SEC. 201. EXPEDITED PROCEDURES FOR FORMING A BANK HOLDING COMPANY.

Section 3(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(a)) is amended—

(1) by striking out "or (B)" and inserting in lieu thereof "(B)",

(2) by inserting before the period at the end of the second sentence the following: "; or (C) with 30 days prior notification to the Board, the acquisition by a company of control of a bank in a reorganization in which a person or group of persons exchange their shares of the bank for shares of a newly formed bank holding company and receive, after the reorganization, substantially the same proportional share interest in the holding company as they held in the bank except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State or Federal law if, immediately following the acquisition, the bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing and controlling banks. In promulgating regulations pursuant to this subsection,

the Board shall not require more capital for the subsidiary bank immediately following the reorganization than is required for a similarly sized bank that is not a subsidiary of a bank holding company".

SEC. 202. EXEMPTION OF CERTAIN HOLDING COMPANY FORMATIONS FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933.

Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended by adding at the end thereof the following new paragraph:

"(7) transactions involving offers or sales of equity securities, in connection with the acquisition of a bank by a company under section 3(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(a)), if the acquisition occurs solely as part of a reorganization in which a person or group of persons exchange their shares of a bank for shares of a newly formed bank holding company and receive, after that reorganization, substantially the same proportional share interests in the bank holding company as they held in the bank, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State or Federal law.".

SEC. 203. EXPEDITED PROCEDURES FOR BANK HOLDING COMPANIES TO SEEK APPROVAL TO ENGAGE IN NONBANKING ACTIVITIES.

Paragraph (8) of section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) is amended—

(1) by redesignating clauses (i) and (ii) of subparagraphs (C), (D), and (E) as subclauses (I) and (II), respectively;

(2) by redesignating subparagraphs (A) through (G), and any cross references thereto as clauses (i) through (vii), respectively; and

(3) by striking out all that precedes "purposes of this subsection it is not" and inserting in lieu thereof the following:

"(8)(A) ACTIVITIES CLOSELY RELATED TO BANKING.—In accordance with the limitations and requirements contained in subparagraphs (B) and (C) of this paragraph, shares of any company whose activities the Board has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto, after taking into account technological or other innovations in the provision of banking or banking-related services.

"(B) NOTICE REQUIREMENTS.—

"(i) No bank holding company shall engage in any activity or acquire the shares of a company pursuant to this paragraph, either de novo or by an acquisition in whole or in part of a going concern, unless the Board has been given 60 days prior written notice of that proposal and, within that period, the Board has not issued an order—

"(I) disapproving the proposal, or

"(II) extending the time period in accordance with clause (iii) below.

"(ii)(I) An acquisition may be made prior to the expiration of the disapproval period if the Board issues a written statement of its intent not to disapprove the proposal.

"(II) The Board may provide for no notice under this paragraph or notice for a shorter period of time with respect to particular activities.

"(III) No notice under this paragraph is required for a bank holding company to establish de novo an office to engage in any activity previously authorized for that bank holding company under this paragraph or to change the location of an office engaged in that activity.

"(iii) The notice submitted to the Board shall contain such information as the Board shall prescribe by regulation or by specific request in connection with a particular notice, except that the

Board may require only such information as may be relevant to the nature and scope of the proposed activity and to the Board's evaluation of the notice under the criteria specified in clause (iv). If the Board requires additional relevant information beyond that provided in the notice, the Board may by order extend the time period provided in clause (i) of this subparagraph until it has received that information, and the activity that is the subject of the notice may be commenced within 60 days of the date of that receipt unless the Board issues a disapproval order as provided in clause (i). Such an extension order is reviewable under section 9 of this Act.

"(iv) In determining whether to disapprove a notice under this paragraph, the Board shall consider whether the performance of the activity described in the notice by a bank holding company or subsidiary thereof can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. In orders and regu-

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lations under this paragraph, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern.

"(v) The Board shall by order set forth the reasons for any disapproval or determination not to disapprove a notice under this paragraph.

"(C) INSURANCE ACTIVITIES NOT CLOSELY RELATED TO BANKING.—For".

SEC. 204. REDUCTION OF POST-APPROVAL WAITING PERIOD FOR BANK HOLDING COMPANY ACQUISITIONS.

Section 11(b)(1) of the Bank Holding Company Act of 1956 (12 U.S.C. 1849(b)(1)) is amended by adding before the period at the end of the fourth sentence thereof the following: "or such shorter period of time as may be prescribed by the Board with the concurrence of the Attorney General, but in no event less than 5 days".

SEC. 205. REDUCTION OF POST-APPROVAL WAITING PERIOD FOR BANK MERGERS.

Section 18(c)(6) of the Federal Deposit Insurance Act (12 U.S.C. 1828(c)(6)) is amended by adding before the period at the end of the last sentence thereof the following: "or such shorter period of time as may be prescribed by the agency with the concurrence of the Attorney General, but in no event less than 5 days".

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II

100TH CONGRESS
1ST SESSION

S. 1891

To establish a Financial Services Oversight Commission, and for other purposes.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 20 (legislative day, NOVEMBER 19), 1987

Mr. WIRTH (for himself and Mr. GRAHAM) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To establish a Financial Services Oversight Commission, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Financial Services Oversight Act".

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SEC. 2. DECLARATION OF PURPOSES.

The purposes of this Act are—

(1) to preserve and strengthen the regulatory and supervisory frameworks associated with banking and other financial services,

(2) to preserve continuity and flexibility of the public safety net surrounding banking and finance,

(3) to respond to functional rather than institutional distinctions with respect to banking and other financial services,

(4) to provide for an appropriate degree of consolidated supervision of diversified financial firms.

(5) to protect depositors, policy holders, and investors by ensuring the integrity of institutions and markets, by providing safeguards from excessive risk, and by ensuring the banking and financial system exercises its fiduciary responsibility with respect to maintaining the value of financial investments,

(6) to assure fairness with respect to the accessibility of capital and credit,

(7) to ensure credit decisions are made impartially,

(8) to promote a balanced distribution of credit in the marketplace,

(9) to preserve competitive equity and enhance market efficiency, and

(10) to prevent conflicts of interest, concentration of financial resources and unfair competitive practices.

TITLE I—FINANCIAL SERVICES OVERSIGHT COMMISSION

SEC. 101. ESTABLISHMENT OF COMMISSION.

There is established in the executive branch a Financial Services Oversight Commission (hereafter referred to as the "Commission") which shall be an independent agency of the United States.

SEC. 102. MEMBERSHIP.

(a) IN GENERAL.—The Commission shall consist of 9 voting members.

(b) VOTING MEMBERS.—

(1) COMPOSITION.—The Commission shall consist of the following voting members:

(A) The Chairman of the Board of Governors of the Federal Reserve System.

(B) The Comptroller of the Currency.

(C) The Chairman of the Board of Directors of the Federal Deposit Insurance Corporation.

(D) The Chairman of the Federal Home Loan Bank Board.

(E) The Chairman of the Securities and Exchange Commission.

(F) The Chairman of the Commodity Futures Trading Commission.

(G) The President of the National Association of Insurance Commissioners.

(H) A Chairman.

(I) A Vice Chairman.

(2) QUALIFICATIONS, TERM, AND APPOINTMENT OF CHAIRMAN AND VICE CHAIRMAN.—

(A) APPOINTMENT.—The Chairman and Vice Chairman shall be appointed by the President, by and with the advice and consent of the Senate.

(B) TERM.—The Chairman and Vice Chairman shall each hold office for a term of 6 years, except that the initial term of the Chairman shall be 5 years and the initial term of the Vice Chairman shall be 2 years. The Chairman and Vice Chairman may hold office until a successor is appointed and qualified.

(c) ADVISORY COMMITTEE.—The Commission shall establish an advisory committee which shall consist of the following members:

(1) A representative of State bank supervisors,

(2) A representative of State thrift supervisors,

(3) A representative from the National Association of Securities Dealers,

(4) A representative of State securities administrators,

(5) The Chairman of the Pension Benefit Guaranty Corporation,

(6) A representative of the State credit union supervisors, and

(7) such other members as the Commission may determine to be necessary to carry out the purposes of this Act.

(d) Compensation of Members.—Each member of the Commission who is not otherwise an officer of the Government of the United States shall be entitled to compensation at a rate not to exceed the daily equivalent of the rate of pay provided for a GS–18 under the General Schedule for each day on which the member is engaged in carrying out responsibilities of the Commission and shall be entitled to reimbursement for travel expenses and per diem in connection with attendance at meetings and hearings of the Commission to the same extent and in the same manner as employees of the Federal Government under subchapter I of chapter 57 of title 5, United States Code.

SEC. 102. DUTIES OF THE COMMISSION.

(a) In General.—The Commission shall—

(1) promulgate regulations defining the types of activities in which bank holding companies, financial holding companies, and commercial holding companies may engage;

(2) take appropriate action to enforce compliance with such regulations either directly or through referrals to primary regulatory agencies;

(3) establish minimum standards of capital adequacy for financial holding companies and their affiliates;

(4) coordinate its activities with the rulemaking and enforcement activities of other Federal agencies and State agencies; and

(5) promulgate regulations to assure that transactions between financial services subsidiaries of all holding companies are conducted in a manner consistent with the purposes of this Act.

(b) CONSULTATION WITH ADVISORY COMMITTEE.—The advisory committee members may attend and participate fully in all formal rulemaking proceedings of the Commission. A proposed rule or regulation may not take effect prior to the expiration of 120 days after submission to the advisory committee which shall have 120 days to review and comment on such proposal.

(c) MAJORITY APPROVAL.—No final action shall be taken with respect to a proposed rule or regulation unless approved by an affirmative vote of not less than 6 voting members of the Commission.

(d) BALANCE OF COMPETITION.—In carrying out its functions, the Board shall—

(1) avoid concentration of financial services in the marketplace, and

(2) assure that there is a balance of competitive equity between nonbank financial companies that are affiliates of banks or financial holding companies on the

one hand, and affiliates of commercial firms on the other.

(c) REFERRAL.—The Commission shall refer any violation of its regulations to the agency having primary regulatory jurisdiction. Such violation shall also be referred to the Board of Governors, if the Board of Governors is not the agency with primary regulatory jurisdiction.

SEC. 164. PERMISSIBLE ACTIVITIES AND INVESTMENTS OF HOLDING COMPANIES.

(a) BANK AND FINANCIAL HOLDING COMPANIES.—A bank holding company or financial holding company may not control any commercial company or engage in any commercial activity.

(b) COMMERCIAL HOLDING COMPANIES.—A commercial holding company may not control a bank or a financial company which holds or offers transaction accounts.

(c) TRANSITION RULES.—The Commission shall by regulation establish a reasonable period of time to provide for the divestiture or other cessation of investments or activities made or first engaged in prior to the date of enactment of this Act.

SEC. 165. RULEMAKING AUTHORITY.

(a) IN GENERAL.—The Commission may issue rules and regulations to carry out the purposes of this Act.

(b) FORMAL RULEMAKING.—Any rule or regulation issued pursuant to this Act shall be made on the record after opportunity for hearing in accordance with sections 553, 556, and 557 of title 5, United States Code.

SEC. 106. REPORTING REQUIREMENTS.

(a) IN GENERAL.—The Commission shall monitor the activities of bank, financial, and commercial holding companies to insure compliance with this Act and the rules and regulations promulgated thereunder. To that end, the Commission may periodically require reports under oath, in such scope and detail as it may determine necessary and proper to insure the purposes of this Act are accomplished.

(b) INFORMATION EXCHANGE WITH APPROPRIATE FEDERAL AND STATE AGENCIES.—The Commission may make available any reports required under this section to the regulatory agency having primary jurisdiction. In the event an agency other than the Board of Governors has primary regulatory jurisdiction, the Commission may make such reports available to the Board of Governors.

SEC. 107. ENFORCEMENT.

(a) IN GENERAL.—If in the opinion of the Commission, any bank holding company, financial holding company, or commercial holding company—

(1) is engaging, has engaged, or is about to engage in, a practice or activity prohibited by the Commission's rules or regulations, or

(2) is in violation of or about to violate a law, rule, or regulation, or any condition imposed in connection with its conduct of a financial service over which the Commission has oversight authority,

the Commission shall immediately notify the regulatory agency having primary jurisdiction and shall forward all supporting documentation to such agency. In the event an agency other than the Board of Governors has primary regulatory jurisdiction, the Commission shall also notify the Board of Governors.

(b) ENFORCEMENT ACTION BY REGULATORY AGENCY.—After notice and hearing, the agency with primary regulatory jurisdiction, or, if appropriate, the Board of Governors, shall have authority with respect to any bank, financial, or commercial holding company, or any other entity engaging in financial services to—

(1) require divestiture with respect to the conduct of any activity which violates the Commission's rules or regulations,

(2) impose additional capital requirements,

(3) issue an order to cease and desist from such violation or practice, or

(4) issue an order imposing civil penalties in an amount not greater than $10,000 per day for each day a prohibited activity or practice is engaged in or a violation is committed, and

(5) bring action in the appropriate United States district court or any other court of competent jurisdiction to enforce an order issued under this title.

(c) DEFINITION OF AGENCY WITH PRIMARY REGULATORY JURISDICTION.—For purposes of this title, the term "agency with primary regulatory jurisdiction" means—

(1) the Financial Services Oversight Commission in the case of a financial holding company or a commercial holding company;

(2) in the case of an insurance company, the State Insurance Commission or Board of the State in which an insurance company is incorporated;

(3) the Securities Exchange Commission in the case of a broker or dealer in securities or in the case of a company which is a holding company with respect to a broker or dealer in securities;

(4) the Comptroller of the Currency in the case of a national banking association, a District bank, or a Federal branch or agency of a foreign bank;

(5) the Board of Governors of the Federal Reserve System—

(A) in the case of a bank holding company and thrift holding company,

(B) in the case of a State member insured bank (except a District bank),

(C) in the case of any branch or agency of a foreign bank with respect to any provision of the Federal Reserve Act which is made applicable under the International Banking Act of 1978,

(D) in the case of any foreign bank which does not operate an insured branch, and

(E) in the case of any agency or commercial lending company other than a Federal agency;

(6) the Federal Deposit Insurance Corporation in the case of a State nonmember insured Bank (except a District bank) or a foreign bank having an insured branch; and

(7) the Federal Home Loan Bank Board in the case of an insured Federal savings bank.

SEC. 108. POWERS OF THE COMMISSION.

In addition to the powers granted to the Commission elsewhere in this title, for purposes of carrying out the provisions of this title, the Commission shall have power—

(1) to enter into contracts, to execute instruments, to incur liabilities, and to do any and all other acts as

may be necessary and incidental to the conduct of its business;

(2) to sue and be sued, complain and defend, in any court of law or equity, State or Federal;

(3) to use the United States mails in the same manner and under the same conditions as other Federal agencies;

(4) to appoint and fix the compensation of such officers, attorneys, and other experts as may be necessary, and, subject to the civil service laws, appoint such other officers and employees as are necessary in the execution of its functions and to fix their salaries in accordance with chapter 51 and subchapter III of chapter 53 of title 5, United States Code;

(5) to lease, purchase, or otherwise acquire, own, hold, improve, use, or otherwise deal in or with, and sell, convey, mortgage, pledge, lease, exchange or otherwise dispose of, any property, real, personal, or mixed, or any interest therein, wherever situated;

(6) to adopt, amend, and repeal regulations relating to the conduct of its business and the exercise of all other rights and powers granted by this Act; and

(7) to secure information directly from any Federal or State regulatory agency. In any case in which the Commission receives any information from a Fed-

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eral or State agency, the Commission shall not disclose such information to the public unless such agency is authorized to disclose such information pursuant to Federal or State law.

SEC. 109. DEFINITIONS.

For purposes of this title:

(1) BANK HOLDING COMPANY.—The term "bank holding company" means any company which controls any other company that holds accounts insured under the Federal Deposit Insurance Act or title IV of the National Housing Act.

(2) FINANCIAL HOLDING COMPANY.—The term "financial holding company" means any company (other than a bank holding company) which controls any other company that offers transaction accounts.

(3) COMMERCIAL HOLDING COMPANY.—The term "commercial holding company" means any company which controls any other company engaged in financial activities (as defined in regulations of the Financial Services Oversight Commission) and which is not a bank holding company or a financial holding company.

(4) CONTROL.—The determination whether any company has control over any other company shall be made in the same manner as under section 2(a)(2) of the Bank Holding Company Act of 1956.

(5) Transaction account.—The term "transaction account" has the same meaning as under the last sentence of section 19(b)(1)(C) of the Federal Reserve Act (12 U.S.C. 461(b)(1)(C)).

(6) Board of governors.—The term "Board of Governors" means the Board of Governors of the Federal Reserve System.

SEC. 110. AUTHORIZATION.

There are authorized to be appropriated such sums as are necessary to carry out the provisions of this title.

TITLE II—AMENDMENTS TO BANKING AND SECURITIES LAWS

SEC. 201. AMENDMENTS TO THE BANK HOLDING COMPANY ACT OF 1956.

(a) Termination of Grandfather Status of Nonbank Bank Holding Companies.—

(1) In general.—Section 4(f) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(f)) is amended by adding at the end thereof the following:

"(11) Termination.—Paragraph (1) shall cease to apply to any company described in such paragraph on January 1, 1998.".

(2) Exemption.—The Board may exempt from the application of the amendment made by paragraph (1) any company to which such provision applies for an

additional period or periods aggregating not to exceed 1 year where necessary to provide for the orderly disposition of insured bank subsidiaries of affected companies.

(b) BANK HOLDING COMPANY ACTIVITIES AFTER MARCH 1988.—Section 4(c)(8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(8)) is amended to read as follows:

"(8)(A) shares of any company the activities of which the Board, after notice and opportunity for hearing, has determined (by order or regulation)—

"(i) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto; or

"(ii) are financial services described in regulations of the Financial Services Oversight Commission.

"(B) In determining for the purpose of subparagraph (A)(i) whether a particular activity is a proper incident to banking or managing or controlling banks, the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

"(C) In orders and regulations under this subsection, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern.

"(D) Notwithstanding any other provision of this Act, if the Board finds that an emergency exists which requires the Board to act immediately on any application under this subsection involving a thrift institution, and the primary Federal regulator of such institution concurs in such finding, the Board may dispense with the notice and hearing requirement of this subsection and the Board may approve or deny any such application without notice or hearing;".

SEC. 202. AMENDMENTS TO TITLE IV OF THE NATIONAL HOUSING ACT.

(a) Termination of Unitary Thrift Holding Company Status.—

(1) In General.—Section 408(c)(3) of the National Housing Act (12 U.S.C. 1730a(c)(3)) is repealed.

(2) Exemption.—The Board may exempt from the application of the amendment made by paragraph (1) any company to which such provision applies for an

additional period or periods aggregating not to exceed 10 years where necessary to provide for the orderly disposition of insured institution subsidiaries of affected companies.

(b) EFFECTIVE DATE.—The amendment made by subsection (a)(1) shall take effect on January 1, 1998.

SEC. 203. AMENDMENTS TO THE FEDERAL RESERVE ACT.

(a) RESERVE REQUIREMENTS APPLICABLE TO CERTAIN TRANSACTION ACCOUNTS.

(1) DEFINITIONS.—

(A) DEPOSITORY INSTITUTION.—Section 19(b)(1)(A) of the Federal Reserve Act (12 U.S.C. 461(b)(1)(A)) is amended—

(i) by striking out "and" at the end of clause (vi);

(ii) by striking out the period at the end of clause (vii) and inserting in lieu thereof "; and"; and

(iii) by adding at the end thereof the following:

"(viii) any other organization that the Board determines by regulation holds transaction accounts which shall be subject to paragraph (2).".

(B) TRANSACTION ACCOUNT.—Section 19(b)(1)(C) of the Federal Reserve Act (12 U.S.C. 461(b)(1)(C)) is amended by adding at the end thereof the following: "Such term also includes, to the extent that the Board by regulation may prescribe, accounts that are held by depository institutions described in subparagraph (A)(viii) against which balances can be drawn by the account holder at par within 24 hours without prior notice for payment to third parties, and that are not insured under the Federal Deposit Insurance Act, title IV of the National Housing Act, or title II of the Federal Credit Union Act.".

(2) AUTHORITY TO IMPOSE.—Section 19(b)(2) of the Federal Reserve Act (12 U.S.C. 461(b)(2)) is amended by adding at the end thereof the following:

"(E) Notwithstanding any other provision of this paragraph, reserves may be required to be maintained with respect to transaction accounts described in the last sentence of paragraph (1)(C)—

"(i) only if the Board makes a determination that such action is necessary in the public interest; and "(ii) in such ratio or ratios as the Board may prescribe.".

(b) LIQUIDITY RESERVE.—Section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b)) is amended by adding at the end thereof the following:

"(12) ELECTRONIC PAYMENTS SYSTEM LIQUIDITY RESERVE.—Each major direct user of large-dollar electronic payment systems shall maintain a liquidity reserve balances in an amount equal to that percentage of its average daily transactions as may be specified by the Board. The Board shall pay interest on liquidity reserve balances maintained under this subsection at a rate for any period that is not lower than the average yield on short-term United States Treasury obligations issued during the preceding period.".

(c) INTEREST ON DEMAND DEPOSITS.

(1) MEMBER BANKS.—Section 19(i) of the Federal Reserve Act (12 U.S.C. 371a) is repealed.

(2) INSURED BANKS.—The first sentence of section 18(g)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) is repealed.

SEC. 204. AMENDMENTS TO THE INTERNATIONAL BANKING ACT OF 1978 AND RELATED LAWS.

Section 4 of the International Banking Act of 1978 is amended by adding at the end thereof the following:

"(k)(1) If the National Electronic Payments Corporation determines that any foreign bank doing business through a Federal branch or agency or through a corporation organized under section 25(a) of the Federal Reserve Act is a major user of the national electronic payments system, the Corporation may, after notice and opportunity for a hearing, issue an order requiring that foreign bank to reorganize in order to conduct all of its activities in the United States through a subsidiary or affiliate of the foreign bank organized under the laws of the United States.

"(2) For the purpose of this subsection, the National Electronic Payments Corporation, the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System are authorized to issue such rules and regulations as may be necessary.".

SEC. 206. AMENDMENTS TO THE BANKING ACT OF 1933.

(a) AFFILIATIONS PERMITTED.—Section 20 of the Banking Act of 1933 (12 U.S.C. 377) is amended—

(1) by inserting "(a)" after "20", and

(2) by adding at the end thereof the following new subsection:

"(b) Notwithstanding any other provisions of this section, a member bank may be affiliated in any manner determined by the Board of Governors of the Federal Reserve

System with a company engaged in activities permitted under section 4(c)(8) of the Bank Holding Company Act of 1956."

(b) INTERLOCKING DIRECTORATES.—Section 32 of the Banking Act of 1933 (12 U.S.C. 78) is amended by adding at the end thereof the following: "Notwithstanding any other provision of this section, an officer, director, or employee of any member bank may serve at the same time as an officer, director, or employee of an affiliate engaged in activities permitted under section 4(c)(8) of the Bank Holding Act of 1956 and the Board of Governors of the Federal Reserve System determines that such service would not unduly influence investment policies of such member bank or the advice it gives its customers regarding investments.".

SEC. 206. AMENDMENTS TO SECURITIES EXCHANGE ACT OF 1934.

(a) REGISTRATION OF BROKERS AND DEALERS.—Section 15 of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following new subsection:

"(f) The Commission shall not grant registration to any broker or dealer unless such broker or dealer establishes to the satisfaction of the Commission that all requirements established by the Financial Services Oversight Commission in connection with the activities of such broker or dealer (including any capital adequacy requirement) have been met.".

(b) REGULATION OF BROKERS AND DEALERS.—

(1) Section 15(b)(4) of the Securities Exchange Act of 1934 is amended by inserting "the Financial Services Oversight Act," after "the Commodity Exchange Act," in subparagraph (D).

(2) Section 15(b)(4) of the Securities Exchange Act of 1934 is amended by inserting "the Financial Services Oversight Act," after "the Commodity Exchange Act," in subparagraph (E).

TITLE III—NATIONAL ELECTRONIC PAYMENTS CORPORATION

SEC. 301. SHORT TITLE.

This title may be cited as the "National Electronic Payments Corporation Act".

SEC. 302. PURPOSE.

It is the purpose of this title to establish a National Electronic Payments Corporation—

(1) to muster the equity investment needed to materially upgrade and streamline the crucial operational systems and backup systems needed to enhance the reliability and integrity of the large-dollar electronic payments system;

(2) to achieve a major step forward in providing finality of payments;

(3) to augment the cash and liquidity balances associated with the operation of the system;

(4) to provide a vehicle through which public and private institutions can work together in securing a safer and more efficient payments mechanism; and

(5) to establish a vehicle which can materially reduce the susceptibility of the payments system to shocks whether they are operational, liquidity, or credit in nature.

SEC. 302. DEFINITIONS.

For the purpose of this title:

(1) BOARD OF DIRECTORS.—The term "Board of Directors" means the Board of Directors of the Corporation.

(2) CORPORATION.—The term "Corporation" means the National Electronic Payments Corporation established by this title.

(3) BOARD OF GOVERNORS.—The term "Board of Governors" means the Board of Governors of the Federal Reserve System.

(4) PRIVATE SHAREHOLDER.—The term "private shareholder" means any depository institution, bank holding company, or financial holding company which the Board of Directors determines has a sufficient level of large dollar transactions to require, or make appropriate, access to the national electronic payments system of the Corporation.

SEC. 304. ESTABLISHMENT OF THE CORPORATION.

(a) ESTABLISHMENT.—There is established the "National Electronic Payments Corporation" which shall be a body corporate and shall be under the direction of a Board of Directors which shall consist of 4 members selected by the Board of Governors and 3 members selected by the private shareholders. The principal office of the Corporation shall be in the District of Columbia or at such other place as the Corporation may prescribe.

(b) POWERS.—The Corporation is authorized—

(1) to adopt, alter, and use a corporate seal;

(2) to have succession until dissolved by Act of Congress;

(3) to make and enforce such bylaws, rules, and regulations as may be necessary or appropriate to carry out the purposes or provisions of this title;

(4) to make and perform contracts, agreements, and commitments;

(5) to prescribe and impose fees and charges for services by the Corporation;

(6) to settle, adjust, and compromise, and with or without consideration or benefit to the Corporation to release or waive in whole or in part, in advance or otherwise, any claim, demand, or right of, by, against the Corporation;

(7) to sue and be sued, complain, and defend, in any State, Federal, or other court;

(8) to acquire, take, hold, and own, and to deal with and dispose of any property;

(9) to determine its necessary expenditures and the manner in which the same shall be incurred, allowed, and paid, and appoint, employ, and fix and provide for the compensation and benefits of officers, employees, attorneys, and agents, all without regard to any other law. Nothing in this title or any other law shall be construed to prevent the appointment, employment, and provision for compensation and benefits, as an officer, employee, attorney, or agent of the Corporation, of any officer, employee, attorney, or agent of any department, establishment, or corporate or other instrumentality of the Government; and

(10) with the consent of any department, establishment, or instrumentality of the Government, to utilize and act through any such department, establishment, or instrumentality and avail itself of the use of information, services, facilities, and personnel thereof, and may pay compensation therefor, and all of the foregoing are authorized to provide the same to the Corporation as it may request.

(c) INVESTMENTS.—Funds of the Corporation may be invested in such investments as the Board of Directors may prescribe. Any Federal Reserve bank or any bank as to which at the time of its designation by the Corporation there is outstanding a designation by the Secretary of the Treasury as a general or other depositary of public money, may be designated by the Corporation as a depositary or custodian or as a fiscal or other agent of the Corporation, and is hereby authorized to act as such depositary, custodian, or agent. When designated for that purpose by the Secretary of the Treasury, the Corporation shall be a depositary of public money, under such regulations as may be prescribed by the Secretary of the Treasury, and may also be employed as fiscal or other agent of the United States, and it shall perform all such reasonable duties as such depositary or agent as may be required of it.

(d) JURISDICTION OF COURTS.—Notwithstanding section 1349 of title 28, United States Code, or any other provision of law, (1) the Corporation shall be deemed to be an agency included in sections 1345 and 1442 of such title 28; (2) all civil actions to which the Corporation is a party shall be deemed to arise under the laws of the United States, and the district courts of the United States shall have original jurisdiction of all such actions, without regard to amount or value; and (3) any civil or other action, case or controversy in a court of a State, or in any court other than a district court of the United States, to which the Corporation is a party may at any time before the trial thereof be removed by the Corporation, without the giving of any bond or security, to the district court of the United States for the district and division embracing the place where the same is pending, or, if there is no such district court, to the district court of the United States for the district in which the principal office of the Corporation, is located, by following any procedure for removal of causes in effect at the time of such removal. No attachment or execution shall be issued against the Corporation or any of its property before final judgment in any State, Federal, or other court.

SEC. 305. DUTIES OF THE CORPORATION.

(a) IN GENERAL.—Subject to policies prescribed by the Board of Directors, the Corporation shall—

(1) establish, operate, and maintain a national electronic payments system to facilitate large dollar transactions, such as funds transfers and transfers of book entry United States Government securities, drawn on accounts at Federal Reserve banks;

(2) promulgate and enforce policies governing standards for utilization of the national electronic payments system, including requirements for the mainte-

nance of liquidity reserve balances in Federal Reserve banks, including a stock subscription requirement;

(3) provide for the development or improvement of telecommunications facilities to operate the national electronic payments system, with appropriate levels of backup and bypass facilities to assure operational reliability of the system;

(4) prescribe procedures relating to the operation of the system, including procedures to enforce compliance with orders of the Financial Services Oversight Commission or the Board of Governors of the Federal Reserve System relating to intraday overdrafts; and

(5) take such other actions as may be necessary to carry out the purpose of this title.

(b) Finality of Payments.—All payments made through the national electronic payments system shall be final and irrevocable upon receipt. To assure that the purpose of this subsection is carried out, the Corporation shall require its shareholders and other persons using the system to establish and maintain appropriate levels of liquidity reserve balances in Federal Reserve banks.

SEC. 306. CAPITALIZATION.

(a) Capital Contributions.—The authorized equity capital of the Corporation shall be $900,000,000, of which—

(1) not to exceed $500,000,000 shall be paid in by the Federal Reserve System; and

(2) not to exceed $400,000,000 shall be paid in by Class A shareholders.

The Board of Directors shall provide for the issuance of stock certificates evidencing ownership of the Corporation.

(b) DIVIDENDS.—The Corporation may from time to time pay dividends to its shareholders. The dividend rate shall be established from time to time by the Board of Directors, taking into account the need to retain sufficient earnings to assure continuing research and development on payment system technology and the establishment and maintenance of an adequate level of capital.

SEC. 307. ACCESS TO THE SYSTEM.

(a) IN GENERAL.—The Board of Directors shall establish a list of banking and other financial organizations which have transactions in funds and government securities of a sufficient magnitude to make their participation as shareholders in the Corporation appropriate. After establishing such list, the Board of Directors shall invite the participation of those organizations as shareholders in the Corporation. In order to encourage membership, the Board of Directors may limit access to the payment system to only those organizations which are shareholders and which have established adequate reserve balances in Federal Reserve banks in accordance with rules prescribed by the Board of Directors.

(b) FEES.—The Board of Directors shall establish and may adjust from time to time a schedule of fees for use of the Corporation's facilities. The initial schedule and any modification thereto shall be subject to approval by the Board of Governors.

SEC. 308. REPORTS TO CONGRESS.

The Corporation shall transmit to the Congress not later than November 1 of each year a report on its activities during the preceding fiscal year.

SEC. 309. AUTHORIZATION OF APPROPRIATIONS.

There are authorized to be appropriated such sums as are necessary to finance the organization costs of the Corporation.

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II

100TH CONGRESS
1ST SESSION

S. 1905

To enhance competition in the financial services sector, and for other purposes.

IN THE SENATE OF THE UNITED STATES

DECEMBER 1 (legislative day, NOVEMBER 30), 1987

Mr. D'AMATO (for himself and Mr. CRANSTON) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To enhance competition in the financial services sector, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Depository Institution Affiliation Act".

FINDINGS AND PURPOSE

SEC. 2. (a) The Congress hereby finds that—

(1) current laws and regulations restrain efficiency, competition and innovation in the design and delivery of financial services to the disadvantage of consumers;

(2) restrictions on ownership of depository institutions and affiliations with other business organizations interferes with their ability to attract and retain capital and managerial resources;

(3) the vulnerability of the financial system and its discrete components is increased and effective monitoring, supervision and coordination of actions during periods of stress is impeded by fragmented and disparate regulation; and

(4) current laws inhibit the ability of domestic financial markets and intermediaries to respond to the serious competitive challenges presented by foreign intermediaries and the globalization of markets.

(b) It is the purpose of this Act to promote the safety and soundness of the Nation's financial system, enhance the quality of regulation and supervision of financial intermediaries and achieve a more efficient market and effective regulatory structure by—

(1) establishing an alternative and comprehensive legislative framework for the creation and regulation of depository institution holding companies;

(2) increasing the capital adequacy of commercial banks, brokers and dealers, and savings and loan associations and other financial companies by eliminating

restrictions on common ownership and affiliation within a depository institution holding company;

(3) permitting affiliates to engage in any activity subject to functional and equal regulation by the appropriate State or Federal regulator;

(4) insulating and protecting insured depository institutions through higher capital requirements, expanded restrictions on relationships with affiliates, broader examination and enforcement authority and increased civil and criminal penalties;

(5) permitting the efficient marketing and distribution of financial services to consumers subject to safeguards against coercive tie-ins and other unfair and abusive practices; and

(6) establishing the National Financial Services Committee to oversee the evolution and supervision of the financial services industry and to report to Congress.

TITLE I—CREATION AND CONTROL OF DEPOSITORY INSTITUTION HOLDING COMPANIES

SEC. 101. (a) DEFINITIONS.—For the purposes of this Act—

(1) the term "depository institution holding company" means a company that—

(A) has filed with the National Financial Services Committee a notice stating such company's intent to comply with the requirements of this section and has not withdrawn such notice; and

(B) controls an insured bank or an insured institution, or either (i) has, within the preceding twelve months, filed a notice under subsection (b) of this section to acquire control of an insured bank, an insured institution, a bank holding company, a savings and loan holding company or a depository institution holding company, which notice has not been disapproved, or (ii) controls a company which has, within the preceding twelve months, filed an application for deposit insurance under section 4 or 5 of the Federal Deposit Insurance Act (12 U.S.C. 1814, 1815) or section 403 of the National Housing Act (12 U.S.C. 1726), which has not been disapproved. The filing of the notice described in subparagraph (A) of this paragraph by a bank holding company that does not control any banks as defined in section 2(c)(1)(B) of the Bank Holding Company Act (12 U.S.C. 1814(c)(1)(B)) which are not insured banks shall result in immediate termination of the status of such company as a bank holding company, and the filing of the notice described in subparagraph (A) of this paragraph by a savings and loan holding company shall result in the immediate termination of the status of such company as a savings and loan holding company;

(2) the term "bank holding company" has the meaning given to it in section 2(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(a));

(3) the term "savings and loan holding company" has the meaning given to it in section 408(a) of the National Housing Act (12 U.S.C. 1730a(a));

(4) except as provided in paragraph 5 of subsection (f) of this section, the term "affiliate" of a company means any other company which controls, is controlled by, or is under common control with such company;

(5) the term "appropriate Federal regulatory agency" means the Comptroller of the Currency in the case of national banks or District banks, the Board of Governors of the Federal Reserve System in the case of member banks (other than national banks), the Board of Directors of the Federal Deposit Insurance Corporation in the case of insured banks that are not

members of the Federal Reserve System (except a District bank), and the Federal Home Loan Bank Board in the case of insured institutions;

(6) the term "insured bank" has the meaning given to it in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)) but shall not include an insured institution;

(7) the term "State" has the meaning given to it in section 3(a) of the Federal Deposit Insurance Act (12 U.S.C. 1813(a));

(8) the term "insured institution" means a Federal savings and loan association, a Federal savings bank, a building and loan, savings and loan or homestead association or a cooperative bank, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, and shall include a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation and a savings bank which is deemed by the Federal Savings and Loan Insurance Corporation to be an insured institution under section 408(n) of the National Housing Act (12 U.S.C. 1730a(n));

(9) the term "company" means any corporation, partnership, business trust, association, or similar organization, or any other trust unless by its terms it must

terminate within twenty-five years or not later than twenty-one years and ten months after the death of individuals living on the effective date of the trust, but shall not include any corporation the majority of the shares of which are owned by the United States or by any State;

(10)(A) the term "control" means the power, directly or indirectly, to direct the management or policies of a company, or to vote 25 per centum or more of any class of voting securities of a company;

(B) no company shall be deemed to control or to have acquired control of any other company by virture of its ownership of the voting securities of such other company—

(i) acquired or held in an agency, trust or other fiduciary capacity;

(ii)(a) acquired or held in connection with or incidental to the underwriting of securities if such securities are held only for such period of time as will permit the sale thereof on a reasonable basis; or

(b) acquired or held in connection with or incidental to market making, dealing, trading, brokerage or other securities related activities and not with a view to acquiring, exercising or transferring any control over the management or policies of such company; or

(iii) acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition;

(C) no company formed for the sole purpose of participating in a proxy solicitation is in control of a company by virtue of its acquisition of voting rights with respect to shares of such company acquired in the course of such solicitation; and

(11) the term "minimum required capital" with respect to an insured bank or insured institution means the amount of capital that is required for it by applicable Federal law or regulation.

(b) CHANGES IN CONTROL OF INSURED BANKS AND INSURED INSTITUTIONS.—No depository institution holding company acting directly or indirectly, or through or in concert with one or more other persons, shall acquire control of an insured bank, an insured institution, a bank holding company, a savings and loan holding company or a depository institution holding company not controlled by such company on the date it became a depository institution holding company, if such acquisition and control occurs through a purchase, assignment, transfer, pledge or other disposition of voting stock of such insured bank, insured institution, bank holding company, savings and loan holding company or depository institution holding company unless the depository institution holding company has complied with the requirements of the Change in Bank Control Act (12 U.S.C. 1817(j)), or the Change in Savings and Loan Control Act (12 U.S.C. 1730(q)(17)), as applicable. Any failure to comply with the preceding requirements shall subject the relevant depository institution holding company to the penalties and other procedures provided in subsections (i) through (m) of this section, in addition to otherwise applicable penalties.

(c) AFFILIATE TRANSACTIONS.—(1) The appropriate Federal regulatory agency may—

(A) upon a finding of probable harm that cannot adequately be prevented by less burdensome rules and regulations, adopt such rules and regulations, consistent with the purposes of this Act, as may be necessary in order to prevent an insured bank or an insured institution that is controlled by a depository institution holding company from engaging in unsafe or unsound practices that involve the depository institution holding company or any of its affiliates including, without limitation, unsafe or unsound practices that involve covered transactions as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c) and any transactions described in paragraph (2) of subsection (a) of section 23B of the Federal Reserve Act (12 U.S.C. 373c–1); and

(B) by rule, regulation or order, exempt any insured bank or insured institution that is controlled by a depository institution holding company or class of such banks or institutions, or any transaction or class of transactions, from any requirement under the preceding subparagraph or under sections 23A or 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1), notwithstanding the provisions of any other law, rule, regulation or order, if the appropriate Federal regulatory agency deems such an exemption to be reasonable and not inconsistent with the purposes of this Act and in the public interest.

(2) Any rule or regulation adopted pursuant to subparagraph (A) of paragraph (1) of this subsection shall be adopted in accordance with section 4 of the Administrative Procedure Act (5 U.S.C. 553), except that the appropriate Federal regulatory agency shall give interested persons an opportunity for oral presentations of data, views, and arguments, in addition to written submissions.

(3) Any transaction that was approved by a Federal regulatory agency prior to the enactment of this Act shall be exempt from any rules or regulations adopted pursuant to subparagraph (A) of paragraph (1) of this subsection.

(4) Subject to subparagraph (B) of paragraph (1) of this subsection, the provisions of sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1) shall be applicable to every insured bank or insured institution controlled by a depository institution holding company in the same manner and to the extent as if such insured institution or insured bank were a member bank; and for this purpose, any company which would be an affiliate of an insured bank or insured institution for purposes of such sections 23A and 23B if such insured bank or insured institution were a member bank shall be deemed to be an affiliate of such insured bank or insured institution.

(5) No insured bank or insured institution that is an affiliate of a depository institution holding company shall, directly or indirectly—

(A) extend credit in any manner to a securities affiliate or a subsidiary thereof,

(B) purchase for its own account assets of a securities affiliate or a subsidiary thereof,

(C) issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of a securities affiliate or a subsidiary thereof, or

(D) extend credit in any manner to any investment company advised by or the shares of which are distributed by a securities affiliate.

(6) Subparagraphs (A) and (B) of paragraph (5) do not apply to any extension of credit by an insured bank or insured institution made to acquire or sell any securities of the United States if—

(A) the extension of credit is to be repaid on the same calendar day,

(B) the extension of credit is incidental to the clearing of transactions in those securities through that insured bank or insured institution, and

(C) both the principal of and the interest on the extension of credit are fully secured by securities of the United States.

(7) No insured bank or insured institution that is an affiliate of a depository institution holding company shall directly or indirectly extend credit, or issue or enter into a standby letter of credit, asset purchase agreement, indemnity, guarantee, insurance, or other facility, for the purpose of enhancing the marketability of a securities issue underwritten or distributed by a securities affiliate.

(8) No insured bank or insured institution that is an affiliate of a depository institution holding company shall knowingly extend or arrange for the extension of credit, directly or

indirectly, secured by or for the purpose of purchasing any security while, or for thirty days after, that security is the subject of a distribution in which a securities affiliate of that insured bank or insured institution participates as an underwriter or a member of a selling group.

(9) No insured bank or insured institution that is an affiliate of a depository institution holding company shall, directly or indirectly, extend credit to an issuer of securities underwritten by a securities affiliate for the purpose of paying the principal of those securities or interest for dividends on those securities.

(10) For the purpose of paragraphs (5), (6), (7), (8), and (9) of this section, a "securities affiliate" means a company that engages in underwriting, distributing or dealing in securities of any type, except that such term shall not include insurance products deemed to be securities, including and without limitation variable annuities and variable life insurance.

(d) CAPITALIZATION.—(1) As a supplement to the minimum capital otherwise required for insured banks or insured institutions, as applicable, that are not controlled by financial services holding companies subject to its jurisdiction, the appropriate Federal regulatory agency may act by regulation to cause each insured bank or insured institution subject to its jurisdiction that is controlled by a depository institution holding company to maintain additional capital in an amount of up to three per centum of such bank's or institution's total assets. Such additional capital may be in the form of either common stock, preferred stock or subordinated debt.

(2) In the event of a finding by the appropriate Federal regulatory agency that an insured bank or insured institution controlled by a depository institution holding company is not in compliance with the applicable minimum required capital for insured banks or insured institutions not controlled by depository institutions holding companies, the depository institution holding company shall (i) execute an agreement with the appropriate Federal regulatory agency within thirty days to return the insured bank or insured institution within a reasonable period of time to compliance with the applicable minimum required capital or (ii) divest control of the insured bank or insured institution in an orderly manner within one hundred eighty days of such additional period of time as the appropriate Federal regulatory agency may determine is reasonably required in order to effect such divestiture.

(3) The appropriate Federal regulatory agency may not impose by regulation, order, agreement or any other means any requirement pertaining to the capital of a depository institution holding company.

(e) Interstate Acquisitions of Insured Banks and Insured Institutions.—(1) No depository institution holding company may acquire control of an additional insured bank if the acquisition could not be approved by the Board of Governors of the Federal Reserve System under section 3(d) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842(d)) were such acquisition made by a bank holding company.

(2) No depository institution holding company may acquire control of an additional insured institution if the acquisition would be in violation of Section 408(e)(3) of the National Housing Act (12 U.S.C. 1730a(e)(3)) were such acquisition made by a savings and loan holding company, except as otherwise authorized pursuant to Section 408(m) of the National Housing Act (12 U.S.C. 1730a(m)).

(f) Differential Treatment Prohibition; Laws Inconsistent With This Act.—(1) Notwithstanding any other Federal law, no State, and no Federal or State regulatory agency, including the appropriate Federal regulatory agency, may act by law, rule, regulation, order, or otherwise if the effect of such action would be to differentiate insured banks or insured institutions controlled by depository institution holding companies from any other insured banks or insured institutions in a manner adverse to insured banks or insured institutions controlled by depository institution holding companies, or to differentiate depository institution holding companies or their affiliates from bank holding companies or savings and loan holding companies and their affiliates in a manner adverse to depository institution holding companies or their affiliates, except to the extent that the appropriate Federal regulatory agency may act to implement this Act as authorized herein.

(2)(A) FINDINGS AND PURPOSE.—The Congress hereby finds that certain State laws and regulations have the purpose or effect of preventing insured banks or insured institutions from being or becoming affiliated with companies or persons engaged in nonbanking activities. Such laws restrain legitimate competition in interstate commerce and deny consumers freedom of choice in selecting financial services. Such restrictions also threaten the long-term safety and soundness of insured banks and insured institutions by denying them access to capital. Given the preponderant Federal interest in ensuring competition in national markets for financial services and in ensuring the safety and soundness of the federally-insured banking and thrift industries, Congress hereby finds that it is necessary to preempt such anticompetitive State laws and regulations to the extent necessary to permit the formation and efficient operation of depository institution holding companies. However, the Congress also recognizes that there is a legitimate and traditional State interest in ensuring that State banks and other companies are operated in a safe and sound manner to serve the interests of the public and consumers. The preemption provided in the following paragraph (B) is thus not intended to preempt State laws that concern the regulation, supervision and examination of State-chartered entities, and that are not inconsistent with the purposes of this Act.

(B) PREEMPTION.—Any provision of Federal or State law, rule, regulation or order that is expressly or impliedly inconsistent with the provisions and purposes of this section is hereby preempted, including, without limitation, State banking, savings and loan, insurance, real estate, securities, finance company, retail or other laws which (i) have the purpose or effect of preventing or impeding insured banks or insured institutions or affiliates, agents, principals, brokers, directors, officers, employees or other representatives of such institutions or affiliates thereof from being owned or controlled by or from being affiliated in any way with a depository institution holding company or any affiliate thereof as a result of the types of nonbanking activities engaged in directly or indirectly by such company or any affiliate thereof or by any agent, principal, solicitor, broker, director, officer, employee or other representative of such company or affiliate thereof or (ii) have the purpose or effect of preventing insured banks or insured institutions or affiliates, agents, principals, brokers, directors, officers, employees or other representatives of such institutions or affiliates thereof from offering or marketing products or services of their affiliated depository institution holding company or any affiliate thereof or from having their products or services offered or marketed by their affiliated depository institution holding company or any affiliate thereof, or by any agent, principal, broker, director, officer, employee or other representative of such company or affiliate thereof.

(3) No State or State regulatory agency may act by law, rule, regulation or order if the effect of such action would be to impede or prevent an insured bank or insured institution that is located in another State from qualifying to maintain or defend in court any action which could be maintained or defended under similar circumstances by a company that is located in such other State and that is not an insured bank or insured institution, provided that the insured bank or insured institution does not establish or operate in any State so acting or in the State of any State regulatory agency so acting a "domestic branch", as defined in section 3(o)); except that, where the maintenance or defense of such an action by a company that is located in such other State and that is not an insured bank or insured institution is subject to certain conditions, the maintenance or defense of such an action by an insured bank or insured institution located in such other State may be subject to those same conditions, so long as such conditions are applied in a nondiscriminatory

manner to fulfill legitimate State objectives and do not have the effect, directly or indirectly, of denying insured banks or insured institutions located in other States the opportunity to maintain or defend such actions.

(4) Except for licensing, marketing, compensation, employment or other requirements applied in a nondiscriminatory manner to fulfill legitimate State regulatory objectives which are not inconsistent with the purposes of this Act as set forth in section 2 hereof, no State may through legislative, administrative, executive or judicial action impede or prevent a depository institution holding company or affiliate thereof from utilizing or compensating any agent, solicitor, broker, employee or other person located in that State and representing in any lawful capacity any insured bank or insured institution or any such depository institution holding company or such affiliate thereof; provided that, where any such person is being utilized or compensated for the performance of activities on behalf of an insured bank or insured institution, such activities do not result in the establishment or operation by the insured bank or insured institution of a "domestic branch," as defined in section 3(o) of the Federal Deposit Insurance Act (12 U.S.C. 1813(a)), at any location other than the main or branch offices of such insured bank or insured institution.

(5) As used in paragraphs (2) through (4) of this subsection only, the term "affiliate" means a person that directly or indirectly controls or is controlled by, or is under common control with the person specified; and the term "control," including the terms "controlled by" and "under common control with", means the power, directly or indirectly, to direct the management or policies of a person and shall be presumed to exist if any person, directly or indirectly, owns, controls, or holds with power to vote ten percent or more of the voting securities of any other person.

(g) SECURITIES, INSURANCE AND REAL ESTATE ACTIVITIES OF INSURED BANKS AND INSURED INSTITUTIONS.—(1) No insured bank or insured institution that is an affiliate of a depository institution holding company shall directly engage in—

(A) dealing in or underwriting securities, or purchasing or selling securities as agent, except to the extent that such activities are performed only with regard to obligations of the United States or would be authorized for a national bank under section 92a of title 12, United States Code;

(B) insurance underwriting; or

(C) real estate investment or development, except to the extent that such activities are performed in relation to the premises of the insured bank or insured institution or in connection with securing or collecting a debt previously contracted in good faith, or would be authorized for a national bank under section 92a of title 12, United States Code.

(2) Nothing contained in this subsection shall be construed (A) to prohibit or impede a depository institution holding company or any affiliate of a depository institution holding company other than an insured bank or insured institution from engaging in any of the activities set forth in paragraph (1), or (B) to prohibit or impede any employee of an insured bank or insured institution that is an affiliate of a depository institution holding company from promoting or advertising products or services of an affiliate of such insured bank or insured institution that engages in any of such activities.

(3) No bank holding company which becomes a depository institution holding company and no depository institution holding company which did not at any time prior to becoming such a holding company directly or indirectly engage in insurance agency or real estate brokerage activities shall commence any insurance agency or real estate brokerage activities not permissible for bank holding companies under section 4(C)(8) of the Bank Holding Company Act of 1956, as amended, (12 U.S.C. 1843(c)(8)), unless such activities shall be conducted through an existing insurance agency or real estate brokerage firm, as the case may be, acquired directly

or indirectly by such depository institution holding company or through any successor to such insurance agency or real estate brokerage, and unless such acquired insurance agency or real estate brokerage firm shall have been actively engaged in such insurance or real estate agency activities during the two-year period preceding the date of enactment of this Act.

(4) Nothing in this subsection shall require the breach of any contract entered into prior to enactment of this Act.

(h) TYING AND INSIDER LENDING PROVISIONS.—(1) A depository institution holding company shall be treated as bank holding company for purposes of section 106 of the Bank Holding Company Act Amendments of 1970 and section 22(h) of the Federal Reserve Act and any regulation prescribed under any such section.

(2) A depository institution holding company and any of such company's other affiliates shall be subject to the restrictions of section 106 of the Bank Holding Company Act Amendments of 1970, in connection with any transaction involving the products or services of such company or affiliate and those of an insured bank or insured institution affiliate, as if such company or any such company's other affiliates were a bank and such insured bank or insured institution were a subsidiary of a bank holding.

(3) For purposes of this subsection, the appropriate Federal regulatory agency shall exercise the rulemaking authority provided to the Board of Governors of the Federal Reserve System in section 106 of the Bank Holding Company Act Amendments of 1970 and section 22(h) of the Federal Reserve Act.

(i) EXAMINATION AND ENFORCEMENT.—(1) The appropriate Federal regulatory agency shall enforce the provisions of this section and any regulations adopted under the authority conferred in this section by using its examination and supervisory powers to ensure that each insured bank or insured institution under its supervision is in compliance with the limitations of this section.

(2) In no instance shall the benefits of Federal deposit insurance coverage applicable to an insured bank or an insured institution that is controlled by a depository institution holding company shall be extended to either such depository institution holding company or to any other company controlled by such depository institution holding company that is neither an insured bank nor an insured institution. Thus the purpose of this subsection (c) is to prevent the resources of the Federal deposit insurance funds from being used to protect the shareholders or business interests of a depository institution holding company, except through the authorized fulfillment of their obligations to protect the insured deposits of

an insured bank or an insured institution that is controlled by a depository institution holding company.

(3) The appropriate Federal regulatory agency may examine the books, records and affairs of, or require reports from, any affiliate of an insured bank or insured institution controlled by a depository institution holding company in order to ensure compliance with the limitations of this section.

(4) Whenever it appears to the appropriate Federal regulatory agency that any depository institution holding company is violating, has violated, or is about to violate any provision of this section or any regulation prescribed under this section, such agency may, in its discretion, apply to the appropriate district court of the United States or the United States court of any territory for—

(A) a temporary or permanent injunction or restraining order enjoining such depository institution holding company from violating this section or any regulation prescribed under this section; or

(B) such other equitable relief, including divestiture, as may be necessary to prevent such violation.

(5) The district courts of the United States and the United States court in any territory shall have jurisdiction and power to issue any injunction or restraining order or grant any other relief described in paragraph (3). When ap-

propriate, any injunction, order, or other equitable relief granted under this subparagraph shall be granted without requiring the posting of any bond.

(6) Whenever it appears to a State or Federal official or agency with supervisory or examination authority over any affiliate of a depository institution holding company that such affiliate or such depository institution holding company is violating, has violated, or is about to violate any provision of this section or of any regulation prescribed under this section, such official or agency shall promptly notify the appropriate Federal regulatory authority in order that the appropriate Federal regulatory authority in consultation with the notifying agency may determine whether action under this subsection is appropriate.

(j) DIVESTITURE.—(1) In addition to all its other regulatory and supervisory powers, if the appropriate Federal regulatory agency determines that an insured bank or insured institution under its supervision has engaged in a continuing course of conduct involving its depository institution holding company or any affiliate of such holding company which has had, or has a significant probability of having, the effect of causing such insured bank or insured institution to be in an unsafe or unsound condition, it may make an initial finding that the depository institution holding company should be required to terminate its control of the insured bank or insured institution. If the appropriate Federal regulatory agency makes such an initial finding, it shall within three days so notify the depository institution holding company controlling the insured bank or insured institution and the National Financial Services Committee. Such notice shall provide a statement for the basis of the appropriate Federal regulatory agency's action.

(2) Within thirty days of the receipt of the notice described in the preceding paragraph, the depository institution holding company receiving such notice may request an agency hearing before the appropriate Federal regulatory agency. In such hearing all issues shall be determined pursuant to section 5 of the Administrative Procedure Act (5 U.S.C. 554). The length of the hearing shall be determined by the appropriate Federal regulatory agency, and such hearing may be before a hearing examiner appointed by such agency. At the conclusion thereof, the appropriate Federal regulatory agency shall issue a final order, on the basis of the record made at such hearing, affirming or reversing the initial finding of the appropriate Federal regulatory agency. A company that files to request an agency hearing under this paragraph shall be deemed to have consented to the issuance of a final order affirming the initial finding without the necessity of the hearing provided for in this paragraph.

(3) If such final order affirms the initial finding, the depository institution holding company shall, upon completion of the judicial review, if any, of the appropriate Federal regulatory agency's final order as provided for in subsection (m), terminate its control of the insured bank or insured institution involved within one year.

(k) CRIMINAL PENALTIES.—(1) Any company, insured bank or insured institution which knowingly and willfully violates or knowingly and willfully participates in a violation of any provision of this section, or any rule, regulation or order issued by an appropriate Federal regulatory agency pursuant thereto, shall upon conviction be fined for each violation not more than the greater of $250,000 or an amount equal to one one-hundredth of 1 per centum of the minimum required capital of the relevant insured bank or insured institution for each day during which the violation continues, except that in no case shall any such amount for any violation or related series of violations exceed 1 per centum of the minimum required capital of the relevant insured bank or insured institution.

(2) Any officer, director, employee or agent of any company, insured bank or insured institution and any other natural person who knowingly and willfully participates in a violation of any provision of this section or any rule, regulation, or order issued pursuant thereto, shall upon conviction be

imprisoned not less than five years and fined for each violation not more than the greater of $250,000 or double the individual's annual compensation at the time the violation occurred.

(3) Every officer, director, employee and agent of a depository institution holding company or insured bank or insured institution also shall be subject to the same penalties for false entries in any book, report, or statement of such company or insured bank or insured institution as are applicable to officers, directors, employees and agents of member banks for false entries in any books, reports, or statements of member banks under section 1005 of title 18.

(1) CIVIL MONEY PENALTIES.—(1) Any company, insured bank or insured institution which violates or participates in a violation of this section or any rule, regulation or order issued by an appropriate Federal regulatory agency pursuant thereto shall forfeit and pay a civil money penalty for each violation of not more than the greater of $250,000 or an amount equal to one-hundredth of 1 per centum of the minimum required capital of the relevant insured bank or insured institution for each day during which such violation continues, except that in no case shall any such amount for any violation or related series of violations exceed 1 per centum of the minimum required capital of the relevant insured bank or insured institution.

(2) Any officer, director, employee or agent of any company, insured bank or insured institution and any other person who participates in a violation of any provision of this section or any rule, regulation or order issued by an appropriate Federal regulatory agency pursuant thereto shall forfeit and pay a civil money penalty of not less than the greater of $250,000 or double the individual's annual compensation at the time the violation occurred.

(3) The appropriate Federal regulatory agency shall have authority to assess such a civil money penalty, after giving notice and an opportunity to the company, insured bank or insured institution, officer, director, employee, agent or other natural person to submit data, views, and arguments, and after giving due consideration to the appropriateness of the penalty with respect to the size of financial resources and good faith of the company, insured bank, insured institution, or natural person charged, the gravity of the violation, the history of previous violations, and any data, views and arguments submitted.

(4) The appropriate Federal regulatory agency may, in its discretion, compromise, modify, or remit any civil money penalty which is subject to imposition or has been imposed. The appropriate Federal regulatory agency may collect such civil money penalty by agreement with the company, insured bank or insured institution or person, or by bringing an action

in the appropriate United States district court, except that in any such action, the company, insured bank or insured institution or person against whom the penalty has been assessed shall have a right to trial de novo.

(m) JUDICIAL REVIEW.—Any party agrieved by an appropriate Federal regulatory agency's findings or other actions under this Act may obtain review by the United States Court of Appeals of the Circuit wherein such party has its principal place of business or the United States Court of Appeals for the District of Columbia Circuit, by filing a Notice of Appeal in such Court within thirty days from the date of such action, and simultaneously sending a copy of such notice by registered or certified mail to the appropriate Federal regulatory agency. The appropriate Federal regulatory agency shall promptly certify and file in such Court the record upon which such action or finding was based. The actions or findings of the appropriate Federal regulatory agency shall be set aside if not supported by substantial evidence or if found to violate procedures established by this Act. An initial finding by the appropriate Federal regulatory agency under subsection (j) of this section shall be subject to judicial review only in the context of review of a final order under paragraph 2 of the subsection (j).

AMENDMENTS TO THE BANK HOLDING COMPANY ACT OF 1956

SEC. 102. Section 2(c)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)) is amended by adding the new subparagraph (K) to read as follows:

"(K) An insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)) that is controlled by no company other than a depository institution holding company as defined in the Depository Institution Affiliation Act.".

AMENDMENTS TO THE FEDERAL RESERVE ACT

SEC. 103. Section 23A of the Federal Reserve Act (12 U.S.C. 371c) is amended by inserting the following at the end of paragraph (a)(2): "*Provided, however,* That notwithstanding the foregoing, a loan or extension of credit shall not be deemed to be made to an affiliate if (i) the member bank approves such loan or extension of credit in accordance with substantially the same standards and procedures and on substantially the same terms that it applies to similar loans or extensions of credit the proceeds of which are not transferred to or for the benefit of an affiliate, and (ii) such loan or extension of credit is not made for the purposes of evading any of the requirements of this section.".

AMENDMENTS TO THE BANKING ACT OF 1933

SEC. 104. (a) section 20 of the Banking Act of 1933 (12 U.S.C. 377) is amended by inserting the following new paragraph after the first paragraph of such section:

"The provisions of this section shall not apply to the affiliation of any bank that is an affiliate of a depository institution holding company as defined in the Depository Instituton Affiliation Act with the depository institution holding company or any other affiliate of the depository institution holding company.".

(b) Section 32 of the Banking Act of 1933 (12 U.S.C. 78) is amended by inserting the following at the end of the first paragraph of such section: "The provisions of this section shall not apply to relationships involving an affiliate of a depository institution holding company as defined in the Depository Institution Affiliation Act and either that depository institution holding company or any other affiliate of that depository institution holding company.".

AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

SEC. 105. (a) Section 7(j)(8)(B) of the Federal Deposit Insurance Act (12 U.S.C. 1817(j)(8)(B)) is amended to read as follows:

"(8)(B) the term "control" means the power, directly or indirectly, to direct the management or policies of a company, or to vote 25 per centum or more of any class of voting securities of a company: *Provid-*

ed, That, no company shall be deemed to control or to have acquired control of any other company by virtue of its ownership of the voting securities of such other company—

"(i) acquired or held in an agency, trust or other fiduciary capacity;

"(ii)(a) acquired or held in connection with or incidental to the underwriting of securities if such securities are held only for such period of time as will permit the sale thereof on a reasonable basis, or

"(b) acquired or held in connection with or incidental to market making, dealing, trading, brokerage or other securities related activities and not with a view to acquiring, exercising or transferring any control over the management or policies of such company; or

"(iii) acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition: *Provided further*, That, no company formed for the sole purpose of participating in a proxy solicitation is in control of a company by virtue of its acquisition of voting rights with respect to shares of such company acquired in the course of such solicitation.".

(b) The last sentence of secttion 7(j)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(j)(1)) is amended to read as follows: "For the purposes of subsection (j), the term 'insured bank' shall include—

"(i) any 'bank holding company', as that term is defined in section 2 of the Bank Holding Company Act, which has control of any such insured bank, and the appropriate Federal banking agency in the case of a bank holding company shall be the Board of Governors of the Federal Reserve System; and

"(ii) any 'depository institution holding company', as that term is defined in section 101(a)(1) of the Depository Institution Affiliation Act, which has control of any such insured bank, and the appropriate Federal banking agency in the case of a depository institution holding company shall be the appropriate Federal regulatory agency, as defined in section 101(a)(5) of the Depository Institution Affiliation Act, of such insured bank, or each such agency, if more than one, in the case of a depository institution holding company which has control of more than one such insured bank.".

(c) Section 18(j)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)(1)) is amended:

(1) by deleting "The" at the beginning thereof; and

(2) by inserting in lieu thereof the following: "Subject to section 101(c)(1)(B) of the Depository Institution Affiliation Act, the".

AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

SEC. 106. (a) REGISTRATION OF BROKERS AND DEALERS.—Section 15 of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following new subsection:

"(f) The Commission shall not grant registration to any broker or dealer unless such broker or dealer establishes to the satisfaction of the Commission that all requirements established by the Depository Institutions Affiliation Act in connection with the activities of such broker or dealer (including any capital adequacy requirement) have been met.".

(b) REGULATION OF BROKERS AND DEALERS.—(1) Section 15(b)(4) of the Securities Exchange Act of 1934 is amended by inserting "the Depository Institutions Affiliation Act," after "the Commodity Exchange Act," in subparagraph (D).

(2) Section 15(b)(4) of the Securities Exchange Act of 1934 is amended by inserting "The Depository Institutions Affiliation Act," after "the Commodity Exchange Act," in subparagraph (E).

AMENDMENT TO THE NATIONAL HOUSING ACT

SEC. 107. (a) Subsection (8)(B) of Section 407(q) of the National Housing Act (12 U.S.C. 1730(q)(8)(B)) is hereby amended to read as follows:

"(B) 'control' means the power, directly or indirectly, to direct the management or policies of a company, or to vote 25 per centum or more of any class of voting securities of a company: *Provided*, That, no company shall be deemed to control or to have acquired control of any other company by virtue of its ownership of the voting securities of such other company—

"(i) acquired or held in an agency, trust or other fiduciary capacity;

"(ii)(a) acquired or held in connection with or incidental to the underwriting of securities if such securities are held only for such period of time as will permit the sale thereof on a reasonable basis; or

"(b) acquired or held in connection with or incidental to market making, dealing, trading, brokerage or other securities related activities and not with a view to acquiring, exercising or transferring any control over the management or policies of such company; or "(iii) acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition: *Provided further*, That, no company formed for the sole purpose of participating in a proxy solicitation is in control of a company by virtue of its acquisition of voting rights with respect to shares of such company acquired in the course of such solicitation.".

(b) The last sentence of section 407(q)(1) of the National Housing Act (12 U.S.C. 1730(q)(1)) is amended to read as follows: "For the purposes of this subsection (q), the term 'insured institution' shall include any savings and loan holding company, as that term is defined in section 408 of the National Housing Act, which has control of any insured institution, and any depository institution holding company, as that term is defined in section 101(a)(1) of the Depository Institution Affiliation Act, which has control of any such insured institution.".

AMENDMENT TO THE COMMUNITY REINVESTMENT ACT

SEC. 108. Section 3(3) of the Community Reinvestment Act (12 U.S.C. 2902(d)) is amended:

(1) by inserting "or notice, as appropriate" after "an application" and before "to the appropriate Federal financial supervisory agency"; and

(2) by adding a new paragraph (G) to read as follows:

"(G) the acquisition of an insured bank or an insured institution requiring prior notice under section 101(b) of the Depository Institution Affiliation Act.".

TITLE II—SUPERVISORY IMPROVEMENTS

NATIONAL FINANCIAL SERVICES COMMITTEE

SEC. 201. (a) ESTABLISHMENT OF NATIONAL FINANCIAL SERVICES COMMITTEE.—There is established a National Financial Services Committee which shall consist of—

(1) the Secretary of the Treasury,

(2) the Chairman of the Board of Governors of the Federal Reserve System,

(3) the Chairman of the Board of Directors of the Federal Deposit Insurance Corporation,

(4) the Chairman of the Federal Home Loan Bank Board,

(5) the Comptroller of the Currency,

(6) the Secretary of Commerce,

(7) the Attorney General,

(8) the Chairman of the Securities and Exchange Commission, and

(9) the Chairman of the Commodities Futures Trading Commission.

For purposes of this Act, the agencies or departments headed by members of the Committee shall be referred to as "member agencies."

(b) CHAIRMAN.—The Chairman of the Committee shall be the Secretary of the Treasury.

(c) COMPENSATION.—Each member of the Committee shall serve without additional compensation, but shall be entitled to reasonable expenses incurred in carrying out the official duties as such a member.

(d) PUBLIC MEETINGS.—The Committee shall hold public meetings at least annually. All meetings of the Committee shall be conducted in conformity with the provisions of section 3(a) of the Government in the Sunshine Act (5 U.S.C. 552b). The Committee may not take any action unless such action is approved by a vote of two-thirds of the members of the Committee.

(e) SECRETARIAT.—The Department of the Treasury shall provide the Secretariat for the Committee and shall assume any expenses arising for execution of the responsibilities of the Committee.

(f) ACCESS TO RECORDS.—For the purpose of carrying out this section, the Committee shall have access to all books, accounts, records, reports, files, memoranda, papers, things and property belonging to or in use by any appropriate Federal regulatory agency.

(g) FUNCTIONS OF THE COMMITTEE.—(1) the Committee shall, insofar as is practicable, establish uniform principles and standards for the examination and supervision of financial institutions and other providers of financial services, which shall be applied by the member agencies.

(2) The Committee shall make recommendations for uniformity in other supervisory matters, such as, but not limited to, identifying financial institutions and other providers of financial services in need of special supervisory attention, the adequacy of supervisory tools for determining the impact of affiliate operations on insured banks and insured institutions and the ability of the member agencies to discover possible fraud or questionable practices.

(3) The Committee shall, from time to time, recommend to the Congress additional measures to strengthen the separation between insured banks and insured institutions controlled by depository institutions holding companies from the activities of any of their affiliates including, the imposition of additional restrictions on interaffiliate transactions and the strict application of Federal deposit insurance coverage only for the benefit of depositors of insured banks and insured institutions that are controlled by a depository institution holding company.

(h) CONSULTATION WITH STATE REGULATORS.—The Committee shall consult with the appropriate organizations representing the State regulators of banks, savings and loan associations, savings banks, securities firms, insurance companies, and other providers of financial services, and as deemed appropriate, meet with such State regulators. The Committee shall invite to each public meeting of the Committee representatives of such organizations.

(i) STUDIES AND RECOMMENDATIONS.—The Committee may conduct or authorize studies to carry out the purposes of this Act. On the basis of such studies, the Committee may make recommendations to the Congress and member agencies concerning the implementation of this Act and changes in statutes and regulations necessary to promote the strength and stability of the Nation's financial system and financial institutions, the competitiveness of providers of financial services in domestic and international markets and the purposes of this Act. Within one year of the enactment of this Act, the Committee shall report to Congress proposed legislative or regulatory actions that will improve the examination process to permit better oversight of all banks and thrifts. In particular, the Committee shall consider whether the number of or compensation for examiners employed by the appropriate Federal regulatory agencies should be increased.

TITLE III—THRIFT IMPROVEMENTS

AMENDMENTS TO THE NATIONAL HOUSING ACT

SEC. 301. (a) Section 408(a)(1)(A) of the National Housing Act (12 U.S.C. 1730a(1)(A)) is amended to read as follows:

"(A) 'insured institution' means a Federal savings and loan association, a Federal savings bank, a building and loan, savings and loan or homestead association or a cooperative bank, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, and shall include a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation and a savings bank which is deemed by the Federal Savings and Loan Insurance Corporation to be an insured institution under subsection (n), but except for purposes of subsection (m) shall exclude any of the foregoing institutions if such institution is controlled by no company other than a depository institution holding company as defined in the Depository Institution Affiliation Act.".

(b) Section 408(d) of the National Housing Act (12 U.S.C. 1730a(d)) is amended—

(1) by striking out all that precedes '(1)' and inserting in lieu thereof the following:

"(d) PROHIBITED TRANSACTIONS.—(1) Except as otherwise provided in this section, no subsidiary insured institution of a savings and loan holding company shall—";

(2) by redesignating paragraphs (1), (2), (3), (4), (5), and (6) as subparagraphs (A), (B), (C), (D), (E), and (F), respectively, and subparagraphs (A), (B), and (C), as clauses (i), (ii), and (iii), respectively; and

(3) by adding at the end thereof the following:

"(2) Notwithstanding any other provisions of this section, a subsidiary insured institution of a savings and loan holding company which meets the qualified thrift lender requirements of subsection (o) shall not be subject to the prohibitions of paragraph (1), provided that the subsidiary insured institution shall be subject to the requirements set forth in section 415 of the National Housing Act (12 U.S.C. 1730h).

"(3) Any application for the Corporation's approval under this subsection which meets all reasonable procedural requirements established by the Corporation shall be deemed to be approved if, by the close of thirty calendar days after its receipt by the Corporation, the Corporation has not notified the applicant that the approval has been withheld.".

(e) Clause (iii) of section 408(e)(1)(A) of the National Housing Act (12 U.S.C. 1730a(e)(1)(A)) is amended to read as follows:

"(iii) to acquire or hold by purchase or otherwise more than 5 per centum of the voting shares of an insured institution not a subsidiary, or of a savings and loan holding company not a subsidiary, or, in the case of a multiple savings and loan holding company, to acquire or retain more than 5 per centum of the voting shares of any company not a subsidiary which is engaged in any business activity other than those specified in paragraph (2) of subsection (c) of this section, except such voting shares as it may otherwise lawfully acquire or hold—

"(a) in an agency, trust or other fiduciary capacity; or

"(b)(1) in connection with or incidental to the underwriting of securities if such securities are held only for such period of time as will permit the sale thereof on a reasonable basis; or

"(2) in connection with or incidental to market making, dealing, trading, brokerage or other securities related activities and not with a view to acquiring, exercising or transferring any control over the management or policies of such company; or "(c) in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition; or

"(d) in the course of a proxy solicitation, by a subsidiary formed for the sole purpose of participating in such proxy solicitation.".

(d) Section 408(g)(2) of the National Housing Act (12 U.S.C. 1730a(g)(2)) is amended—

(1) by striking "or" at the end of subparagraph (A);

(2) by striking the period at the end of subparagraph (B) and inserting "; or" in lieu thereof; and

(3) by adding the following new subparagraph (C):

"(C) any savings and loan holding company or any subsidiary thereof if, throughout two of the three preceding fiscal quarters, each of its insured institution subsidiaries has been in compliance with the qualified thrift lender requirements of subsection (o)."

(e) Section 408(i) of the National Housing Act (12 U.S.C. 1730a(i)) is amended—

(1) by adding "or" at the end of paragraph (1);

(2) by striking out paragraph (2); and

(3) by redesignating paragraph (3) as paragraph (2).

(f) Title IV of the National Housing Act (12 U.S.C. title IV) is amended by adding at the end thereof new sections 415 and 416 (12 U.S.C. 1730h and 1730i), to read as follows:

"Sec. 415. (a) Except as otherwise provided in subsection (b), the provisions of sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1) relating to transactions between member banks and their affiliates shall apply to each insured institution in the same manner and to the same extent as if such insured institution were a member bank, and for this purpose, any company which would be an affiliate of such insured institution for purposes of such sections 23A and 23B if such insured institution were a member bank shall be deemed an affiliate of such insured institution; provided however, that the Corporation may waive, by rule or order, any provision in sections 23A or 23B if, in the opinion of the Corporation, the terms of a transaction that would otherwise be subject to such provision would not be detrimental to the interests of such insured institution's savings account holders or to the insurance risk of the Corporation with respect to such insured institution.

"(b) Notwithstanding the foregoing, and subject to section 101(c)(1)(B) of the Depository Institution Affiliation Act, an insured institution that is an affiliate of a depository institution holding company, as defined in the Depository Institution Affiliation Act, shall be subject to the provisions of sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c) relating to transactions between member banks and their affiliates in the same manner and to the same extent as if such insured institution were a member bank, and for this purpose, any company which would be an affiliate of such insured institution for purposes of such sections 23A and 23B if such insured institution were a member bank shall be deemed an affiliate of such insured institution.

"(c) For purposes of subsections (a) and (b)—

"(1) the Corporation may prescribe rules or regulations for purposes of clarifying the applicability of sections 23A and 23B to insured institutions; and

"(2) the term 'Board' in such sections 23A and 23B means the Corporation.

"(d) the provisions of subsections (g) (1)–(8) and (h)(1)–(6) of section 22 of the Federal Reserve Act (12 U.S.C. 375a(1)–(8), 375b(1)–(6)), relating to loans to executive officers of banks and prohibitions respecting loans and extensions of credit to executive officers and directors of banks, shall be applicable to (i) every insured institution in the same manner and to the same extent as if such insured institution were a member bank and (ii) every holding company of an insured institution in the same manner and to the same extent as if such holding company were a bank holding company.

"Within one hundred and eighty days of the date of enactment of this Act, the Corporation shall adopt regulations that implement the statutory provisions made applicable to insured institutions, their officers and directors, and officers and directors of their holding companies by this subsection (d) and that substantially conform to the regulations promulgated by the Board of Governors of the Federal Reserve System. The Corporation shall ensure continued substantial conformity with the Board's regulations by adopting additional conforming regulations within one hundred and eighty days of any modifications in the Board's regulations.".

(g) Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by adding at the end thereof the following new subsection:

"(u)(1) FINDINGS AND PURPOSE.—The Congress hereby finds that certain State laws and regulations have the purpose or effect of preventing insured institutions from being or becoming affiliated with companies or persons engaged in nonbanking activities. Such laws restrain legitimate competition in interstate commerce and deny consumers freedom of choice in selecting financial services. Such restrictions also threaten the long-term safety and soundness of insured institutions by denying them access to capital. Given the preponderant Federal interest in ensuring competition in national markets for financial services and in ensuring the safety and soundness of the federally-insured thrift industry, Congress hereby finds that it is necessary to preempt such anticompetitive State laws and regulations to the extent necessary to permit the formation and efficient operation of savings and loan holding companies. However, the Congress also recognizes that there is a legitimate and traditional State interest in ensuring that State thrifts and other companies are operated in a safe and sound manner to serve the interests of the public and consumers. The preemption provided in the following subsection (2) is thus not intended to preempt State laws that concern the regulation, supervision and examination of State-chartered entities, and that are not inconsistent with the purposes of this section.

"(2) PREEMPTION.—Any provision of Federal or State law, rule or regulation that is expressly or impliedly inconsistent with the provisions and purposes of this section is hereby preempted, including, without limitation, State banking, savings and loan, insurance, real estate, securities, finance company, retail, or other laws which are inconsistent with this section and which (A) have the purpose or effect of preventing or impeding insured institutions or affiliates, agents, principals, brokers, directors, officers, employees, or other representatives of such institutions or affiliates thereof from being owned or controlled by or from being affiliated in any way with a savings and loan holding company or any affiliate thereof as a result of the types of nonbanking activities engaged in directly or indirectly by such company or any affiliate thereof or by any agent, principal, solicitor, broker, director, officer, employee, or other representative of such company or affiliate thereof or (B) have the purpose or effect of preventing insured institutions or affiliates, agents, principals, brokers, directors, officers, employees, or other representatives of such institutions or affiliates thereof from offering or marketing products or services of their affiliated savings and loan holding company or any affiliate thereof or from having their products or services offered or marketed by their savings and loan holding company or any affiliate thereof, or by any agent, principal, broker, director, officer, employee, or other representative of such company or affiliate thereof.".

(h) Section 408(r) of the National Housing Act (12 U.S.C. 1730a(r)) is amended—

(1) by striking "or" at the end of subparagraph (2)(C);

(2) by striking the period at the end of subparagraph 2(D) and inserting "; or" in lieu thereof; and

(3) by adding at the end thereof the following:

"(E) such an affiliation or officer, director, or employee relationship between an organization described in paragraph (1) and an insured institution which meets

The **Chairman**. Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator **D'Amato**. Mr. Chairman, I want to welcome Alan Greenspan to the committee this morning to discuss legislative proposals to reform the laws governing the financial services industry.

Chairman Greenspan in his testimony specifically addresses proposals introduced by you, Mr. Chairman, and Senator Garn, The Financial Modernization Act; and Senators Wirth and Graham's proposal, the Financial Services Oversight Act.

While I applaud the efforts of my colleagues, I would hope that they, Chairman Greenspan, and other witnesses appearing before the committee will direct their attention to a bill which Senator Cranston and I will introduce at noon today. This legislation is entitled the Depository Institution Affiliation Act of 1987. The legislation draws on the previous efforts of Senators Proxmire, Garn, Wirth and Graham, the recommendations of the FDIC report entitled "Mandate for Change," many of the recommendations contained in Chairman Greenspan's testimony today and before the House Banking Committee, and the recommendations of the Financial Services Council.

The Depository Institution Affiliation Act addresses all of the concerns raised by Chairman Greenspan in arguing for reform of the financial services industry. The legislation briefly, Mr. Chairman, would permit banks to respond to new competitive conditions at home and overseas. It would enable consumers to realize lower costs through expanded competition in all lines of financial products and services.

It would recognize the benefits of permitting financial services to be delivered through the holding company framework. It would recognize the need to strengthen holding company firewalls. It would restrict bank lending to all affiliates of the bank holding company. It would prevent conflicts of interest as a result of strong anti-tie-in legislation and strong civil penalties as well as criminal penalties.

It would increase capital adequacy requirements of banks and thrifts who opt into the holding company structure, something which I think is very, very important. And it would promote a system based on functional regulation. If you're in the securities area, you should be regulated by the SEC. If you're in the banking area, then the appropriate regulator would be the banking regulators.

The Depository Institution Affiliation Act therefore addresses each of the concerns articulated by Chairman Greenspan. However, unlike S. 1886, which Chairman Greenspan seems to be endorsing this morning, the Depository Institution Affiliation Act is broader in scope. It creates an alternative regulatory structure which permits under a holding company structure commercial banks, investment banks and other providers of financial services and products to be affiliated with each other.

I will not go into an exhaustive analysis of the bill at this time since we will be introducing it later today. I believe that this proposal merits the attention of Chairman Greenspan and hopefully other members of this committee.

Chairman Greenspan, you can be sure Senator Cranston and I will be looking forward to your comments on our proposal.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

First of all, welcome, Chairman Greenspan, and I'd like to say at the outset, to express my own view, that Congress clearly ought to be the ones that write the law or set the law in this area and whether we act before the moratorium expires or whether we act after it expires, I think that the pattern of activity ought to be driven by the written law and not in any other way. So hopefully we can see that happen.

There are a number of proposals on the table. You comment on some today in your prepared remarks. There may be additional proposals to look at beyond that.

So I think clearly we've got an active debate going and in a sense I think the broader the debate, the more participants in it, the better the end result is likely to be.

So I'm going to be very interested not only in having you highlight your comments today for us but to respond to questions that we have.

I'd like to also say that since you've taken over at the Fed, it's, one might say, been an exciting time—probably too exciting. But I think the view is widely shared here that was expressed in a Wall Street Journal piece the other day that you really have stepped into that job strongly and have served well in a difficult time, and I know I appreciate that and I think that's the general feeling I hear from colleagues in the Senate. So I just want to acknowledge that and thank you for those efforts and know that they will continue.

The CHAIRMAN. Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

In passing the Competitive Equality Banking Act this past summer, we in Congress took an oath to do two things. First, we promised to conduct a comprehensive review of our banking and financial laws and make decisions on the need for financial restructuring legislation before March 1, 1988, when the moratorium expires on expanded products and services for banks.

Second, we vowed not to extend the moratorium even if we were not able to pass a bill by that time.

Mr. Chairman, you have worked hard to see that Congress keeps its word on both promises and I support your efforts completely. The committee has held extensive hearings on the changing markets for financial products, on the tremendous technological innovations and on the impact of internationalization of capital markets. Combining these with hearings in the three previous Congresses, we now have thousands and thousands of pages of testimony on the need for restructuring the financial services industry.

Although I look forward to these hearings, I suppose I've become a little bit weary after 13 years. Chairman Proxmire and I sat here 13 years ago and he even before that, talking about the need to modernize our financial structure. If anybody had told me that I would serve for 13 years and we still were struggling with the problem, I wouldn't have believed it.

I suggest that it is way past time for us to take action. Today, we do begin consideration of legislative proposals growing out of that hearing record. I am pleased that Senator Proxmire and I have agreed to cosponsor S. 1886, The Financial Modernization Act. This is the bill that would substantially reform the Glass-Steagall Act while leaving intact the authority of the States to prescribe and regulate the insurance and real estate activities of their State-chartered institutions.

I have already inserted a lengthy floor statement in the record detailing my reasons for supporting the bill which, I will not repeat here. I would only say that I think it is now a very good bill, despite some reservations that I still have.

I also welcome other efforts by members of this committee to address the important issues we face by putting new proposals on the table. Senators Wirth and Graham have sponsored a very thoughtful and ambitious bill that is consistent with the Proxmire-Garn bill, but it is more far-reaching. The Financial Services Oversight Act would truly change the landscape of the financial services industry and its regulators.

Likewise, as Senator D'Amato has said, he and Senator Cranston are joining today in a separate bi-partisan effort to introduce a bill that would go even further.

It's rather comforting to know that Senator Proxmire and I have become the real moderates on this committee by merely promising to repeal substantial portions of Glass-Steagall.

In these hearings during the next 2 months, I am hopeful that we can air all the issues, reach a consensus on the type of legislation we want to send to the House, and hopefully the House, after decades of inaction, will decide it's time to do something about the problem.

Turning to today's hearing, I certainly wish to welcome Chairman Greenspan in his first appearance in his capacity as Chairman of the Federal Reserve Board. I'm very pleased that the board has taken such a strong position in favor of the Financial Modernization Act.

I would like, however, to sound a note of caution. The board has applauded our bill's approach for preempting State law in conducting new securities activities through a holding company affiliate regulated by the board. Your testimony views this as a possible precedent for the consideration of other products and services.

Let me say here that I do not agree. I reluctantly agreed to preempt State law only because securities activities have been regulated primarily at the Federal level for the past 50-odd years. That is not true of other financial products like insurance. I will strongly oppose any efforts to take this authority away from the States, just as Senator Proxmire and I opposed this effort in 1984.

Again, Mr. Chairman, I applaud your efforts to keep this committee's first commitment to consider new legislation well before the expiration of the moratorium. We have enough time to move a bill through the Senate and we certainly should do so.

Chairman Greenspan, I am pleased that you're here today to testify before the committee.

The CHAIRMAN. Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

First, may I congratulate you, Mr. Chairman, on the speed with which you have submitted a proposal that is so satisfactory to so many.

Also, I welcome you, Chairman Greenspan, with us again today. We appreciate you taking your time to share with us your opinions on some of the proposals.

Mr. Chairman, I have a couple of brief comments, but may I ask that my statement be printed in full in the record?

The CHAIRMAN. Without objection, so ordered.

Senator SHELBY. The moratorium, as most of us already know, will expire on March 1. This moratorium has brought us some time and it is hoped that we will put that time to good use.

I would like to see a viable blueprint solidified as soon as possible. While I agree that the banks' ability to compete has been sorely limited, safety and soundness and the protection of government subsidies remain my primary consideration.

Today, I am specifically interested in what you, Chairman Greenspan, feel were the public policy implications of the stock market's recent volatility. Immediately after the crash, opponents of the repeal of parts of Glass-Steagall said, "Aha, aren't we all glad that Glass-Steagall is intact?" Of course, the other side of the coin is the argument that banks survived fine, but the recent scare indicates the need to strengthen banks by providing new sources of profit and allowing banks to diversify risks.

I would like to hear your analysis, Mr. Chairman, of the specific improvements in the health of the banking industry and the corresponding diminished threat to bank health that future market volatility would pose if Chairman Proxmire's bill became law.

I would also appreciate it, Mr. Chairman, if you would address once again the issue of concentration in the financial industry. You have said that the Federal Reserve Board could tolerate provisions limiting the merger of large banks and securities firms, but that you did not embrace the provision.

During your confirmation hearing you said you knew of no particular advantage enjoyed by superlarge banks. The greatly diminished stature of American banks among the world's largest banks seem to be cause for alarm to me. In your opinion, does the Proxmire-Garn bill provide for the creation of financial services companies that will be competitive in the influence and in the capabilities of the global marketplace?

[The complete prepared statement of Senator Shelby follows:]

STATEMENT OF SENATOR RICHARD SHELBY
SENATE BANKING COMMITTEE
DECEMBER 1, 1987

MR. CHAIRMAN, I COMMEND YOUR LEADERSHIP IN DRAFTING THIS LEGISLATION WHICH WILL RENOVATE THE FINANCIAL SERVICES INDUSTRY. IN MY OPINION, YOU HAVE DONE AN ADMIRABLE JOB OF DISMANTLING THE BARRIERS THAT PREVENT BANKS FROM COMPETING WHILE AT THE SAME TIME RETAINING THE SAFETY AND SOUNDNESS THAT MUST REMAIN INHERENT IN OUR NATION'S BANKING SYSTEM.

I ALSO APPRECIATE CHAIRMAN GREENSPAN TAKING THE TIME TO APPEAR BEFORE OUR COMMITTEE TODAY TO GIVE US FIRSTHAND HIS APPRAISAL OF THIS LANDMARK LEGISLATION.

WE ARE FAMILIAR WITH THE ALLEGATIONS THAT EXISTING LAW, PARTICULARLY THE GLASS-STEAGALL PROVISIONS, HANDCUFFS BANKS' ABILITY TO COMPETE. A LAW DRAFTED IN 1933 COULD NOT FORESEE THE MODERN DAY ENVIRONMENT IN WHICH BANKS MUST COMPETE, AN ENVIRONMENT SHAPED BY UNPRECEDENTED DEVELOPMENTS IN COMMUNICATIONS AND DATA TRANSFER TECHNOLOGY. THE EFFICIENCIES AFFORDED BY MODERN INNOVATION HAVE ENABLED BANKS' TRADITIONAL CUSTOMER BASE TO TURN TO MORE COST-EFFECTIVE METHODS OF OBTAINING CAPITAL. CONSEQUENTLY, BANKS HAVE SEEN THEIR MARKET SHARE AND PROFIT MARGINS ERODE. THIS EROSION HAS NOT BEEN UNDETECTED BY THE MARKETPLACE; INDEED BANKS' STOCK VALUES SHARE THE SAME MARKET ESTIMATION AS STEEL AND RAILROAD INDUSTRY EQUITIES. IN MY MIND, THIS INDICATES AN ALARMING NEED TO REASSESS THE SAFETY AND SOUNDNESS PROVIDED FOR BANKS BY EXISTING LAW.

THE CHAIRMAN'S BILL PROVIDES FOR THE SAFETY AND SOUNDNESS OF BANKS BY PROVIDING NEW WAYS IN WHICH BANKS MAY DIVERSIFY THEIR SERVICE OFFERINGS. BANKS ARE ALLOWED TO UNDERWRITE MUNICIPAL REVENUE BONDS AND OFFER MUTUAL FUNDS. OTHER ACTIVITIES REMAIN THE JURISDICTION OF SECURITIES AFFILIATES, SEPARATED FROM THE BANK BY AFFILIATE STATUS WITHIN A HOLDING COMPANY STRUCTURE.

WHILE BANKS MAY ARGUE THAT THE PROVISIONS CREATING SUPPOSED FIREWALLS MAY HINDER SOME OF THE ECONOMIES THEY HOPE TO ACHIEVE BY ACQUIRING NEW POWERS, I BELIEVE THE ISSUE OF SAFETY MUST COME FIRST. THE MARKET CRASH OF OCTOBER 19 SERVES AS A SOBERING REMINDER OF THE NEED TO DETACH MORE RISKY ACTIVITIES FROM THE GOVERNMENT SUBSIDIZED BANK AFFILIATE AND SUBSEQUENTLY THE NECESSITY OF ADEQUATE CAPITALIZATION FOR ALL AFFILIATES.

ONCE AGAIN, I APPRECIATE CHAIRMAN GREENSPAN'S PRESENCE HERE TODAY. I LOOK FORWARD TO BENEFITTING FROM HIS WISDOM AND EXPERIENCE AND TRUST THAT THE DISCUSSION TODAY WILL BE ENLIGHTENING.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman.

I want to commend you on the stimulating series of hearings that you've scheduled for the next 2 weeks. I am very pleased that the committee is moving forward with legislation as we promised during the debate on the Competitive Equality Banking Act, and I compliment you and Senator Garn on setting forth an excellent working document for us to begin these discussions.

Witnesses before the committee this year and, as Senator Garn has noted, in past years, have argued very convincingly that the traditional legal barriers between different types of financial institutions have been eroded by changing technology, the increasing internationalization of the financial markets and judicial and regulatory decisions. In particular, the distinction between commercial and investment banking has eroded.

The technology of securitization has permanently changed the delivery of credit and thus many traditional banking businesses are no longer profitable.

In response to this pressure, banks are heavily involved in the securities business overseas and have exploited loopholes to expand the U.S. security operations as well.

Securities firms have also gotten into the banking business by offering transaction accounts, by making bridge loans to finance hostile takeovers, and by underwriting commercial paper and bonds to provide credit previously provided by banks.

Senator Proxmire and Senator Garn have attempted to remedy this situation with the introduction of The Financial Modernization Act. The legislation addresses some of the inequities in the current system and I commend you, Mr. Chairman and Senator Garn, for your hard work in hammering out differences.

I do not support every provision in the bill, but I do believe it is an excellent starting point. I am concerned that the Proxmire-Garn bill does not set up a genuine two-way street between banks and securities firms. The whole purpose of the legislation is to right inequities and inconsistencies. We may not be advancing the cause of reform if all we do is change the list of inconsistencies in our laws.

In addition, I am somewhat troubled by the implication that this bill has for State law and the dual banking system. I understand and respect the reasons why one wants the powers to be conducted in affiliates under Fed supervision, but I am concerned that by effectively cutting States out of the business of authorizing securities powers we are taking the first step toward junking the dual banking system.

I am reluctant to trample on States' rights and responsibilities in any situation, absent a very clear and demonstrated Federal need to do so.

The committee's agenda has been broadened as has been noted beyond S. 1886 by the recent introduction of the Corrigan proposal by Senators Wirth and Graham, and by the bill to be introduced today by Senator D'Amato and Senator Cranston. These broader bills will contribute to the committee debate if they make us focus on the long-term goal that we are trying to achieve: to-wit, a stable internationally competitive U.S. financial system that serves the needs of American consumers and businesses.

At this time, however, I am inclined to support a one-step-at-a-time approach to financial services restructuring. The need to address Glass-Steagall and the barriers between commercial and investment banking seems stronger to me than the need to rewrite all of our banking laws before the end of the 100th Congress.

Comprehensive proposals broaden the debate and it may be possible to enact a sweeping reform bill, but we should focus on the narrower and more achieveable issues first.

I look forward to the testimony of Chairman Greenspan today. I join with the others in welcoming him back to this committee. I would only note modestly that when he was here for his confirmation hearing I did question his reasoning in wanting to take on the job of Federal Reserve Chairman and at the time, Mr. Chairman, I assure you I had no idea that October 19 was going to happen and I will reserve the question that I asked at the confirmation hearing for later discussion.

The CHAIRMAN. Thank you, Senator Bond.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman. Senator Graham and I greatly appreciate not only the expedition with which you've scheduled these hearings but your great expressed desire to work with us in seeing if we might be able to fit together the thrust of many of the things you have in your bill, S. 1886, and the thrust of our legislation, S. 1891. As you know, we believe by introducing S. 1891, which is built upon many of the ideas suggested by Mr. Corrigan, we believe that a structure is something we ought to be looking at, not just the narrow issue of bank powers.

In our legislation, what we have attempted to do is to set up a regulatory process—and we discussed this at great length last week—a regulatory process which can rationalize the system to try to coordinate existing jurisdiction. We also seek a broader reach, to try to say where are we now and what kind of a structure we want reaching out into the rest of this century and reaching out across the world. Not just a structure that just focuses narrowly on what goes on in the United States today.

In addition, what we have attempted to do, Mr. Chairman, is to define a payments system that can respond to the pressures of crisis conditions and not in the process contribute to or maybe even accelerate the crisis conditions. Mr. Chairman, I urge everyone to reread the Wall Street Journal which describes so well the crisis of the day after Monday, October 19. It describes the severe problems of payments that existed in the markets on a megascale. I think the crisis of the payments system was very real and any system that we develop legislatively here has got to also focus on that.

It's my own belief that our financial system presently might be described as a number of Model T's traveling on what has to be a 21st century financial freeway. What we have to do is to modernize our regulatory structure to meet the needs of the future, both domestically and internationally.

Senator Graham and I differ, I think, from what we've heard in part from many in the administration. We differ in that we believe that this financial structure is truly special. It can't be treated like a utility and it can't be deregulated like trucking or like airlines or whatever. This is a very, very special process. It undergirds everything that goes on in the economy and, consequently, we have to assume that deregulation is not the goal; that deregulation or regulation is a means toward some further goal.

So, therefore, we have to start by stating those goals and those are clearly laid out in our legislation—protecting depositors, ensuring investors, providing safeguards against excessive risks, and ensuring impartial credit decisions.

Our legislation, we believe, sets up a broader process and I believe to responsibly address this issue we not only have to look at the more narrow and perhaps more comfortable issues of powers, which have been brought up in Senator Proxmire's bill, but we have to look at how do all of these pieces fit together. And if we can't do it today, what kind of a process do we kick in that is going to force all of the various jurisdictions to sit down together and to coordinate this looking toward the future? That must be done.

Now we also recognize—and I will close with this, Mr. Chairman—that in taking on this process we are embarking upon a minefield, that this is an area surrounded by all kinds of veto power. Everybody out there has the ability to move in here with their very, very well-honed power groups and say, no, no, no. Do this for everybody else, but leave our industry alone. That simply is not going to be adequate to do the kind of far-reaching job that we have to do.

So I hope, Mr. Chairman, that we will be able to follow the approach that you've taken and that we have taken and have the opportunity to fit the two together.

I have a much more extensive and detailed statement which I would like to have included in full in the record if I might at this point.

The CHAIRMAN. Without objection, so ordered.

Senator WIRTH. Thank you, Mr. Chairman. And, Mr. Greenspan, we are delighted to have you with us today and look forward to your testimony.

[The complete prepared statement of Senator Wirth follows:]

Remarks of Timothy E. Wirth

Thank you, Mr. Chairman. I commend you for these thorough hearings on the issue of financial restructuring. My colleague from Florida, Mr. Graham, and I have introduced legislation based on a proposal set forth by E. Gerald Corrigan, President of the Federal Reserve Bank of New York. We appreciate your willingness to consider this proposal along with the bill you have introduced on financial restructuring.

Many of the legislative proposals discussed to date focus only on expanding powers in the financial markets. The primary issue, however, is not one of which powers to grant which financial institution. Rather, we need to put into place a farsighted structure to oversee these markets as they evolve and change in a dynamic international financial arena..

We are faced today with an antiquated financial infrastructure - resembling a Model T automobile - that is forced to travel on a modern electronic highway. Our public sector Model T cannot keep up with our domestic private sector. As a result, our domestic financial markets are at a distinct disadvantage with our international competitors.

In addressing the issue of financial restructuring, I believe we must be guided by several critical public policy goals:

- To strengthen the regulation, supervision and the public safety surrounding banking and finance;
- To consolidate supervision by function rather than by institutional distinctions;
- To protect depositors, policy-holders and investors by ensuring the integrity of institutions and markets, and by providing safeguards from excessive risk;
- To assure fairness in accessibility of capital and credit, ensure impartial credit decisions, promote balanced distributions of credit in the marketplace, preserve competitive equity and market efficiency and prevent conflicts of interest, excess concentration of financial resources or unfair competitive practices.

While Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance, I addressed many of those same principles and sought a regulatory structure that would achieve them. I proposed a capital markets commission, whose goal was to evaluate the nation's long-term capital requirements and examine changes in financial structure and regulation from a broad public policy perspective. My subcommittee held exhaustive hearings on restructuring and introduced legislation that focused on the regulatory structure rather than powers as the primary objective.

I believe Congress' first priority is to ensure that the government's responsibilities for maintaining a stable and sound financial environment can be met. Evidence of the need to strengthen the framework and tools government uses to perform that task is abundant. Our priority needs must include:

1. A framework for supervision and regulation that fits the kind of system that has evolved over the last decade, and can adapt as the system continues to evolve in the future.
2. A payments system that can respond to the pressures of crisis conditions, rather than contribute to or even cause further crises.
3. A financial safety net that can truly protect the small saver from the loss and inconvenience of financial failures without encouraging risk taking and rewarding the speculator.

We currently have an environment in which financial services have become homogenized and barriers between sectors and products have fallen. The Corrigan proposal provides a framework for coordinating diverse and often contradictory regulatory strategies. It is a thoughtful blueprint for modernizing ways in which government can meet its responsibilities. Specifically:

- o A 15-member Financial Services Oversight Commission would be created made up of nine voting members and six advisory members.

the qualified thrift lender requirements of subsection (o).".

(i) Section 408(p) of the National Housing Act (12 U.S.C. 1730a(p)) is amended—

(1) by striking the period at the end of subparagraph 2(B)(ii) and adding "; or" and

(2) by adding at the end thereof the following:

"(iii) the subsidiary insured institution meets the qualified thrift lender requirements of subsection (o).".

AMENDMENT TO THE DEPOSITORY INSTITUTIONS MANAGEMENT INTERLOCKS ACT

SEC. 302. Section 205 of the Depository Institutions Management Interlocks Act (12 U.S.C. 3204) is amended by adding at the end thereof the following:

"(7) A savings and loan holding company, as defined in section 408(a)(1)(D) of the National Housing Act (12 U.S.C. 1730a(e)(1)(D)), the subsidiary insured institution or institutions of which meet the qualified thrift lender requirements of section 408(o) of the National Housing Act (12 U.S.C. 1730a(o)) unless the Federal Home Loan Bank Board determines after notice and opportunity for comment that the interlocking services of a management official with a nonaffiliated depository institution or depository holding company would result in a monopoly or substantial lessening of competition, and the services provided by the management official are not structured or limited so as to preclude such anticompetitive results.".

EFFECTIVE DATE

SEC. 303. This Act shall take effect upon enactment.

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- The nine voting members would be the chairmen of the national regulatory agencies and the six advisory members would represent state regulators. This Commission would provide an umbrella supervisory structure.
- The Commission could regulate activities of banking, financial and commercial holding companies and establish minimum standards of capital adequacy for financial holding companies.
- The separation of banking and commerce would be preserved.
- Bank (thrift) holding companies could own and control banks or thrifts, and could engage in a broad range of financial services. Bank holding companies could not be controlled by a non-financial commercial concern or engage in non-financial activities.
- Financial holding companies could not be owned by a commercial firm. They could offer non-insured transaction accounts. A financial holding company could also choose to own and control insured banks and thrifts, thereby voluntarily shifting its status to a bank or thrift holding company.
- Commercial holding companies could engage in commercial enterprises of their choice, including non-bank activities.
- Commercial holding companies could not own or control a bank or thrift, would be barred from direct access to the payments system and would not receive liquidity assistance from the central bank.

The legislation Senator Graham and I are introducing today embodies the essence of the Corrigan proposal. The bill reflects a realistic assessment of the extent to which financial functions and products have been regulated to date. But more importantly, it provides an orderly framework for further integration of financial services well into the future.

We are introducing the bill primarily to add to and complement the debate as the Banking Committee addresses a new series of hearings on financial restructuring. We reserve the right to alter the proposal as we proceed through the deliberative process.

For example, we may find that this proposal gives too much policy-making authority to the regulators, powers that are primarily the responsibility of Congress. We may also need to extend the transition periods for the proposed structural changes that would take place. In addition, it is clear to me that we need to address the financial safety net in its entirety, and this proposal does not do so. As financial services become more integrated there will be increased pressures on the existing government guarantee programs. This is a vital problem that Congress must soon address.

Mr. Chairman, we have introduced the "Financial Services Oversight Act" as a functional regulatory framework. We are experiencing a time of increased interdependence and inherent fragility of our financial system. The bill is directed toward maintaining and enhancing public confidence in our financial markets, so that these markets can continue to raise the capital needed to fund long term economic growth.

The CHAIRMAN. And a statement by Senator Alan Dixon who had to leave will be printed in the record at this point.

[The complete prepared statement of Senator Dixon follows:]

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. I am pleased to be here this morning as the Banking Committee begins 6 days of hearings on banking reform legislation. There are currently two major reform proposals before the committee, S. 1886, the Financial Modernization Act of 1987, introduced by the distinguished chairman of the committee, Senator Proxmire, and the distinguished ranking Republican, Senator Garn; and S. 1891, the Financial Services Oversight Act, introduced by two very thoughtful members of this committee, Senators Wirth and Graham.

S. 1886 focuses on Glass-Steagall Act issues, and S. 1991 is based on the proposals Gerald Corrigan, president of the New York Federal Reserve Bank, made to the committee earlier this year.

As we begin these hearings I would like to make only two brief points. First, I think it is very important for the committee to report reform legislation before March 1 of next year. I think it is important to maximize the chances for enactment of legislation in this Congress, and that means sending a bill to the House just as rapidly as is possible.

Second, I hope everyone that has an interest in the reform process will work with the committee to report a bill within that time period. However, whether or not the committee is able to act, I want to make it clear that this is one Senator that will do everything he can to make sure that the moratorium is not extended. The moratorium was intended to create a brief period of time for the committee to address the fundamental reform issues we have not successfully addressed over the past several years. It was not intended as a substitute for making those long overdue reform decisions.

If Congress is again unable to address the reform issues, legislatively, therefore, the courts and the regulators will be making the decisions. So those with an interest in reform have a choice: Either work with the Congress on reform legislation, or be prepared to work with the regulators and the courts, because one way or another, reform will happen. To the extent that I have anything to say about it, the moratorium will not be allowed to be used to freeze the status quo beyond March 1, 1988.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you very much, Mr. Chairman.

Welcome, Mr. Chairman. Nice to have you here today.

Because of the time, I have a statement which I would like to be included in the record but I'm very anxious to hear our distinguished witness today. With all the unrest around the world, I think some reassuring words would be of great benefit, far more than my statement for the record.

I also have a statement of Senator Karnes to be inserted in the record.

[The complete prepared statements of Senators Hecht and Karnes follow:]

STATEMENT OF SENATOR HECHT

Senator HECHT. Thank you Mr. Chairman. I want to commend you and Senator Garn on your efforts in formulating S. 1886. Having long been an advocate of legislation along these lines, the time has come when we must now make the difficult decisions which will allow for greater competition in our financial services industry.

However, while restructuring our system, we must take great care to protect the safety and soundness of our markets. As we have recently observed, the confidence the public has in our system, goes a long way in determining what happens in our markets. I think S. 1886 goes along way in providing the protection that the consumer demands and deserves.

I am also particularly supportive of applying "functional regulation" to the different types of services offered by a firm. Functional regulation is imperative in trying to obtain competitive equality in our financial system. S. 1886 takes many of the needed steps in obtaining functional regulatory framework.

As with all legislation, I see areas where this bill could be improved, and I look forward to hearing from our esteemed witness today to get his input on this proposal or any alternative proposals. Thank you Mr. Chairman.

OPENING STATEMENT OF SENATOR DAVID K. KARNES

Senator KARNES. Thank you Mr. Chairman. I want to join with my colleagues who have complimented you Mr. Chairman for your determination to move this process forward. It is the responsibility of this committee and this Congress to address the need for congressional action in the area of financial reform. As Chairman Greenspan expressed in his written testimony, it is our task to reconcile the outdated financial structure with the rapidly changing marketplace for financial services.

The Financial Modernization Act of 1987 introduced by Senator Proxmire and Senator Garn is certainly a step in the right direction. As we all know from previous legislative experience, the final product of this effort will probably be significantly different than the bill that we are discussing today and over the next several weeks. However, I think it is a good starting point and I want to take this opportunity to compliment Chairman Proxmire and Senator Garn in their efforts to achieve a bipartisan compromise. I also want to thank Chairman Greenspan for taking time to provide this committee with his insight on the need for financial reform. I certainly look forward to his testimony on this very important issue. Thank you.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator **Sarbanes**. Thank you, Mr. Chairman. I want to join my colleagues in welcoming Mr. Greenspan to the committee. I'm obviously looking forward to his testimony.

There will be a number of proposals before the committee that address this issue of the structure of our financial institutions. It's obviously a matter of considerable import and I hope out of the course of these hearings we're going to be able finally to distill some knowledge.

I think it's very important, given the economic turmoil and uncertainty of recent weeks, that the question of safety and soundness, which it seems to me has always been an essential premise as we address the questions of structure in the financial sector, be given very careful attention.

We don't have to go too far back in our history to see the extraordinary economic impact which improper structuring can have and I think that the events of recent weeks have underscored the necessity of addressing that issue very carefully indeed.

Second, there's not much talk nowadays as we consider this matter about the question of the concentration of economic power, but I think it's a significant and relevant issue. And as we consider financial restructuring, we have to make some projections about what it's going to mean in terms of how economic decisions are made.

For many businesses and individuals, the access to credit is critical and how changes will impact on that access I think is another issue that needs to be very carefully looked at.

We have heard reference to the international dimension and I think it's obviously a relevant consideration. There seems to be a relative paucity of good, hard material on that. I don't know how much the Fed has available, but specifically in that area I think it might be very helpful if we could develop more extensive material on that dimension of this issue.

Mr. Chairman, those are only some of the questions that I think are at issue and that need to be looked at very carefully as we embark on this set of hearings and begin to relate them specifically to proposals that are before the committee. I see we have an extensive hearing list over the next couple of weeks and that will give us an opportunity at the end of that to see whether we've covered all the bases in terms of the kind of testimony I think we ought to have in order to address this problem adequately.

Thank you.

The **Chairman**. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator **Sasser**. Thank you, Mr. Chairman.

Mr. Chairman, the legislation that we begin hearings on today is perhaps the most important that has been considered by this committee during all the years that I've been a member. I want to compliment you for your leadership, Mr. Chairman, and that of Senators Garn and Wirth and Graham, and I understand even Senators Cranston and D'Amato have now joined the fray and are putting forth significant legislation of their own.

Generally, I would say that reform and restructuring of the financial services marketplace is overdue. There have been vast changes that have occurred in the past few years and they have occurred largely without regulatory supervision.

Many of these changes have been to the detriment of the banking industry as we have known it traditionally over the years. Advances in technology, exploitation of loopholes, deregulation, developments on the international scene have had an impact, I believe, without an appropriate response from this body.

We need to begin to develop an orderly and realistic regulatory scheme for financial institutions that will take into account past market developments and have the flexibility to anticipate what might come in the future.

I think in fashioning that scheme we must not lose track of the goal to ensure maximum benefits to consumers and to permit the most efficient use of our financial resources. That's the reason for there being a financial services industry in the first place.

Also, we must not lose track of the goal of ensuring the safety and soundness of the banking system.

Now I think there are persuasive arguments for some expansion of bank powers and Mr. Chairman, these arguments are becoming more convincing every day. In particular, there's evidence that consumers, local governments and businesses could be benefited as a result of decreased underwriting costs and greater convenience should banks have some securities powers.

However, I think we will all agree there must be stringent regulatory safeguards. The Glass-Steagall Act, rightly or wrongly—I think rightly—was enacted as a response to the perception that bank securities activities were a factor in the crash of 1929 and the ensuing depression that it took us almost 12 years to come out from under. Indeed, we didn't recover from it until the Second World War.

Now we are faced with the unavoidable question of whether the existence of Glass-Steagall in 1987 prevented the stock market crash of some 6 or 7 weeks ago from wreaking havoc once again on the banking industry. Some say that it was the response of the Federal Reserve—and I'm pleased to say that the Chairman, Mr. Greenspan, learned from history and did not repeat the experience of 1929—but some say the response of the Fed and the existence of deposit insurance saved us this time and I think probably the jury is still out on that matter.

But another concern is the concentration of financial power that could develop in the economy if industries with great financial power were combined.

Mr. Chairman, you have pointed the way in exposing the danger of this concentration of financial power. Repeatedly throughout your distinguished career here in the U.S. Senate, you have sounded the alarm of the danger of undue concentration of financial power. And the bill that you offer places some limitation on mergers between large firms and I believe as you do that this country's economy has thrived over the years in part due to the fact that we have 14,000 separately owned commercial banks. Most of these banks are community-oriented; they are very, very important in States such as my own.

So in conclusion, Mr. Chairman, I wish to point out that this committee is doing what it set out to do when we passed the Competitive Equality Banking Act. We have reviewed the situation and we are now moving forward with significant banking legislation and I'm pleased that we are beginning with a witness as extraordinarily qualified as the Chairman of the Federal Reserve Board, Dr. Greenspan, and I'm looking forward to his testimony today.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Sasser.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, I want to commend both you and Senator Garn, as I have on what seems like many other occasions, for holding hearings on this subject.

I join you in welcoming Alan Greenspan and I suppose what is different about this hearing than others is that there are some new and specific proposals before the committee. While much of the testimony I expect will be the same, nonetheless, there have been a large number of changes in the financial institutions industry over the last several years and I think the discussions that we will have in the course of these hearings will reflect those changes.

The market forces that I refer to are obvious. They have certainly blurred the line between certain lending activities and securities activities to the point where many of the legal barriers are, for all practical purposes, either artificial or useless.

In addition to that, regulatory and judicial decisions have accelerated the breakdown of those formerly clear lines.

I think it's also fair to say that with the passage earlier this year of the Competitive Equality Banking Act, this committee, including myself, pledged to undertake a comprehensive review of the entire financial institutions issue and I do commend all who have engaged in this work so far, but I do believe we have a good deal that we all need to learn.

The **Chairman**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

I would like to request permission to submit for the record my full opening statement.

The **Chairman**. Without objection, so ordered.

Senator **Graham**. I express my appreciation to you for having scheduled this series of hearings. I think it is important that we look broadly and futuristically at the financial institutions structure in this country; that we have had too many instances in which we were reactive and focused on narrow immediate crises. We committed ourselves to the broader look. I believe we start today down that path and I hope that within the time constraints that were set out in the Competitive Equality Banking Act of 1987 that we will be able to complete this urgent obligation of the Congress to continue its primary role as the policymaker for America's financial institutions.

[The complete prepared statements of Senators Graham and Cranston follow:]

OPENING STATEMENT OF SENATOR BOB GRAHAM

Senator **GRAHAM**. Mr. Chairman, when the Congress passed the competitive equity banking bill this past summer we said we had a "plumbers' bill" to take care of the immediate weak spots in an outdated system, at the same time we promised the review of our financial industries that responsible planning for the future requires, we called that the "architects' bill."

At present the traditional narrow lines of banking and commerce are blurring as the industry responds to change. Loopholes and court challenges and the variable nature of international and domestic economics have altered the landscape. While Congress has waited the world has not.

We have had a patchwork approach to change. Patches in a climate as volatile as the global financial market are too risky. If we are to allow the industry to develop naturally without sacrificing security—then we must allow for more choices and we must provide for accountable regulations. The Congress must reassert its traditional primary role in establishing the structure of America's financial systems. We face a strong sense of commitment and desire to use the time we have now to be proactive and look at our financial industry as it is currently operating and not from a postage stamp view.

Everyone can benefit if Congress can design a "user friendly" banking industry for the 21st century, the users of financial services all benefit from the increased competitiveness and security and availability of those services. The small depositor gets greater security. The Government users, municipal bond financing for public projects, get a more competitive market. The corporate community can more readily access U.S. banks for its needs because those banks can be more active in the existing global financial market.

Mr. Chairman, let me compliment you on the hearings you are starting today. We are moving ahead in our attempt to review and evaluate the financial industry. The Proxmire-Garn bill, S. 1886, and the Wirth-Graham bill, S. 1891, along with other ideas are all taking a longer view of the financial market structure and putting it on the table. We are all confident these bills will encourage the kind of probing and exhaustive consideration of the future of our financial industries which an architectural approach demands.

Whatever emerges intact as a piece of legislation will have at least started the discussion and debate. For the American consumer and the financial industry the debate should conclude with a realistic and contemporary, secure and prudently regulated system to provide America's financial services—now and well into the 21st century.

STATEMENT OF SENATOR ALAN CRANSTON

Senator CRANSTON. Senator D'Amato and I have introduced a bill to fundamentally restructure the present regulatory system governing the U.S. financial services industry. The proposal, S. 1905, the Depository Institution Affiliation Act [DIAA], would enable consumers and businesses to obtain better and more competitively priced financial services, while at the same time strengthening the safety and soundness of our Nation's depository institutions.

This modernization of our financial services regulatory structure is urgently needed. Current laws and regulations governing financial services are inefficient and obsolete. As a result, American consumers and businesses pay billions more for financial services than they need to, and the financial products they purchase are not as good as they could otherwise be if it were not for the contraints of our present legal structure. Our financial institutions cannot fully complete, either at home or abroad in an increasingly integrated global marketplace. As a result, consumers are being shortchanged and America is falling behind.

Earlier this year, in considering the Competitive Equality Banking Act [CEBA], members of the Senate Banking Committee acknowledged the need to consider the overall structure of our financial regulatory system during the 1 year moratorium imposed by CEBA until March 1988. It was the desire of a majority of committee members to develop a practical solution to the longstanding turf fight that develops every time we attempt to consider piecemeal the various aspects of this structural debate. At that time committee members pledged to reconsider the interrelationships of all of the components that make up our financial system, not merely to debate a series narrowly construed amendments to the Glass-Steagall Act which fail to equitably address all of the fundamental questions involving affiliations with federally insured depository institutions.

I believe that present political considerations must be refocused in terms of the public benefits that would result from an open and competitive marketplace. In doing so it is our obligation to provide for a structure which ensures the safety and soundness of the Nation's financial system as well as the availability of innovative financial products and services for consumer, business and government at the lowest possible cost.

Our objective in introducing the Depository Institution Affiliation Act is to advance the debate beyond the consideration of securities powers for bank holding companies, to the more fundamental issues encompassing competitive equality for every sector of this complex financial services industry. In doing so we have attempted to embody the principles of functional regulation without regard to ownership and control. At the same time, we have attempted to enhance the safety and soundness of not just insured depository institutions, but the system as a whole. We believe this proposed legislation achieves that objective in a manner consistent with the broadest possible public policy concerns.

Under the provisions of the Depository Institution Affiliation Act, any company could become a depository institution holding company and thus, be affiliated with a bank or thrift. A company that chooses this alternative regulatory format could engage in an expanded range of activities with and through its depository institution and other affiliates, provided they complied with the bill's enhanced regulatory requirements and the insured depository institutions were properly insulated. Nondepository financial and/or commerical activities would be conducted through separately capitalized subsidiaries and regulated along functional lines. Regulation would be comprehensive, with additional statutory safeguards supplementing present law in order to better insulate the depository institution affiliate and prevent abuses. Federal regulators would be given significantly expanded oversight authority and enforcement capabilities. Finally, the bill would also establish more consistency between the regulation of thrift holding companies and depository institution holding companies, helping to attract new capital to the troubled thrift industry.

The provisions of the Depository Institution Affiliation Act very closely parallel the recommendations contained in the recently released FDIC study on the structure of our Nation's financial system. In addition, they have been endorsed in concept by a number of academics and other industry leaders. We believe this is a good approach from which to begin the indepth discussion needed before the financial system can be reformed.

The CHAIRMAN. Thank you, Senator Graham.

Well, Mr. Greenspan, you're a patient man. You've had to wait a long time. We are looking forward to your testimony. Go right ahead, sir.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

Mr. Chairman and members of the committee, I welcome this opportunity to present the Federal Reserve Board's views on modernizing our financial system to adapt it to the important changes in technology and competition that have already transformed financial markets here and abroad.

The majority and minority leadership of this committee have taken a major step forward in this modernization process by putting before you, with their full endorsement, a bill which addresses what is perhaps the single most important anomaly that now plagues our financial system—the artificial separation of commercial and investment banking. That bill, S. 1886, The Financial Modernization Act of 1987, is also precedent-setting because it establishes a framework that can be tested and, if it proves adequate as we expect it will, should serve as a foundation on which to build more generally for the future.

I want to express the appreciation of the Board to Chairman Proxmire and Senator Garn for providing this committee with an excellent framework on which to launch the necessary reforms. In our view, we now have an historic opportunity to put the financial system on a sounder footing, perhaps a unique opportunity to make it more responsive to consumer needs, more efficient, more competitive in the world economy, and equally important, more stable.

At the same time, I would also like to thank Senators Wirth and Graham for their most useful contribution to the legislative effort now going forward in this committee and I look forward to Senators Cranston and D'Amato's endeavor to put forward a still further expansion on this issue.

SUPPORT FOR LEGISLATION

A very persuasive case has been made for adoption of the proposal to repeal the Glass-Steagall Act contained in S. 1886. It would allow lower costs and expanded services for consumers through enhanced competition in an area where additional competition would be highly desirable. It would strengthen banking institutions, permitting them to compete more effectively at home and abroad in their natural markets for credit that have been transformed by revolutionary developments in computer and communications technology.

It could be expected to result in attracting more equity capital to the banking industry where more capital is needed. In sum, the securities activities of banking organizations can provide important public benefits without impairing the safety and soundness of banks if they are conducted by experienced managers, in adequately capitalized companies, and in a framework that insulates the bank from its securities affiliates.

BENEFITS OF MODIFICATION

The major public benefit of Glass-Steagall modification would be lower customer costs and increased availability of investment banking services, both resulting from increased competition in an industry that is already concentrated and the realization of possible economies of scale and scope from coordinated provision of commercial and investment banking services. We believe that the entry of bank holding companies into securities underwriting would, in fact, reduce underwriting spreads and, in the process, lower financing costs to businesses large and small, as well as to State and local governments. In addition, bank holding company subsidiary participation in dealing in currently ineligible securities is likely to enhance secondary market liquidity to the benefit of both issuers and investors. These, we believe, are important public benefits that will assist in making our economy more efficient and competitive.

NEW TECHNOLOGY

There is another important reason why the Glass-Steagall Act should be changed. Developments in computer and communications technology have reduced the economic role of commercial banks and enhanced the function of investment banking. These developments mean that investors are increasingly able to make their own evaluations of credit risk, to deal directly with borrowers, and especially with increasing institutionalization of individuals' savings, creditors are in a position to develop their own portfolios and strategies to balance and hedge risk. Thus, the franchise of bank intermediation, the core element of a bank's comparative advantage, and its main contribution to the economic process—credit evaluation and the diversification of risk—has been made less valuable by this information revolution.

Without the repeal of Glass-Stegall, bank share of credit markets is likely to decline as it already has in our measures of short and intermediate short-term business credit.

Society would lose the existing expertise and infrastructure of banking and bear the costs of the redeployment of bank resources as personnel and capital moved to nonbanking organizations. Instead, a soundly structured change in the law will allow financial markets to provide better service by lowering costs to users while strengthening financial institutions within a framework that will protect the financial integrity of banks.

Fundamental to our recommendation on repeal of Glass-Steagall and to our assessment that potential adverse effects in securities activities are thoroughly manageable, is the view that securities activities should be conducted behind walls designed to separate, insofar as possible, the bank from the risks associated with the securities activities.

We see two major elements to an approach toward developing a practical insulating structure. One, the holding company structure should be used to institutionalize separation between a bank and a securities affiliate; and, two, the resulting institutional firewall should be strengthened by limiting transactions, particularly credit transactions, between the bank and its securities affiliate.

The Board believes that the holding company approach adopted by S. 1886, reinforced by the measures I will outline below, has important advantages over other methods of expanding powers of banking organizations. Most important, any losses that may be incurred by the securities affiliate would not be reflected in the balance sheet or income statement of the bank as they would under normal accounting rules if the bank conducted the securities activities directly or through a subsidiary of the bank.

A bank affiliated with a securities firm through a holding company structure thereby obtains the advantages of the holding company's diversification into securities activities without the disadvantages that necessarily flow from the bank conducting the securities activities directly or through a subsidiary of the bank.

A second major element of the separateness structure is to assure that corporate separateness firewalls are not impaired and that the risks of securities activities are not passed on to an affiliated bank.

S. 1886 adopts a number of important measures to accomplish this goal. They are:

Bank lending to and purchase of assets from securities affiliates is prohibited.

Banks are prohibited from enhancing the creditworthiness of securities underwritten by a securities affiliate through guarantees or other techniques.

Banks may not lend to insurers of securities underwritten by a securities affiliate for the purpose of paying interest or principal on such securities.

Banking organizations may not lend to customers for the purpose of purchasing securities underwritten by a securities affiliate during the distribution period and for 30 days thereafter.

Interlocks between the officers and directors of banks and those affiliate securities firms are limited.

Securities affiliates are required to prominently disclose that its obligations or the securities that it underwrites are not the obligations of any bank and are not insured by a Federal agency.

Finally, securities affiliates and banking organizations must be adequately capitalized.

In this connection I want to stress the full support of the Board for the concept of functional regulation incorporated into S. 1886. We agree that a securities subsidiary of a bank holding company carrying out the functions of a broker-dealer should be subject to the net capital requirements of the SEC and should, indeed, be regulated by that body once it has been established.

We do believe, however, that there is a proper role for regulation of a company that owns a bank. As provided under current law, a company that owns a bank should have competent management, should be adequately capitalized, and should be open to review in as unobtrusive a manner as is possible consistent with achieving these goals.

MINIMIZE REGULATION

We also support minimizing regulatory burdens wherever possible. Accordingly, we endorse the provisions of title II generally on "Expedited Procedures" and, particularly, section 203 of the bill which speeds up the holding company applications procedure for approved holding company activities by changing it into a no objection arrangement and by eliminating the cumbersome requirements for formal hearings. We also endorse the provisions of the bill which allow the Board to take into account technological or other innovations in the provision of banking or banking-related services in making judgments on whether an activity is so closely related to banking as to be a proper incident thereto. We believe that these provisions, which have had the Board's support for a number of years, will reduce regulatory burdens and introduce needed flexibility into the regulatory process.

With the strong system of firewalls that are contained in S. 1886 in place, we believe it is appropriate to allow the joint banking-securities enterprise the opportunity to realize the efficiencies that may be achieved by combining services that are functionally so closely linked. Thus, in our view, the approach taken in the bill of permitting use of similar names and coordinated marketing of products is appropriate. We believe that a prohibition on these activities would produce only small gains for bank insulation, but the losses to efficiency would be high.

We believe that repeal of Glass-Steagall should not lead to a concentration of resources. As I have stressed today, it will increase the number of viable competitors in both the banking and securities industries, enhancing competition in both. As a result, we doubt that the Congress need go beyond the requirements of the antitrust laws to anticipate a problem with concentration of resources in the emerging financial services industry. However, because we see as one of the major advantages to repeal to be an expected increase in competition and because we could understand anxieties that this goal might be impaired by a combination of the largest banking and securities firms, the Board does not oppose the limited provisions of section 102 of S. 1886 aimed at preventing the largest banking and securities organizations from consolidating.

We commend this committee for its active role in considering one of the most important issues that now faces our financial markets. We strongly recommend that you adopt legislation to repeal the Glass-Steagall Act and to put in its place a new framework allowing the affiliation of banking organizations and securities firms as provided in The Financial Modernization Act proposed by Chairman Proxmire and Senator Garn.

We also urge you to allow the moratorium on banking activities contained in title II of CEBA to expire on March 1, 1988, as the law now provides. We believe that these measures will ensure a more responsive, competitive and safe financial system.

Thank you, Mr. Chairman.

[The complete prepared statement of Alan Greenspan follows:]

For release on delivery
10:00 a.m., E.S.T.
December 1, 1987

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing & Urban Affairs

United States Senate

December 1, 1987

Mr. Chairman, members of the Committee, I welcome this opportunity to present the Federal Reserve Board's views on modernizing our financial system to adapt it to the important changes in technology and competition that have already transformed financial markets here and abroad. Earlier this year, during its consideration of CEBA, this Committee came to the conclusion that the laws governing financial activities are in need of major repairs and that there is an urgent need for Congressional action to this end. As I read the record, this Committee, and then the Congress as a whole, accepted the task of reconciling the present outdated financial structure with the realities of a changed marketplace for financial services and pledged to move ahead promptly to develop the necessary legislation.

The majority and minority leadership of this Committee have now taken a major step toward fulfillment of this promise by putting before you, with their full endorsement, a bill which addresses what is perhaps the single most important anomaly that now plagues our financial system -- the artificial separation of commercial and investment banking. That bill, S. 1886 - the Financial Modernization Act of 1987 -- is also precedent setting because it establishes a framework that can be tested and, if it proves adequate as we expect it will, should serve as a foundation on which to build more generally for the future.

I want to express the appreciation of the Board to Chairman Proxmire and Senator Garn for providing this Committee with an excellent framework on which to launch the necessary reforms. In our view, we now have an historic opportunity to put the financial system on a sounder footing -- perhaps a unique opportunity to make it more responsive to consumer needs, more efficient, more competitive in the world economy, and equally important, more stable. At the same time, I would also like to thank Senators Wirth and Graham for their most useful contribution to the legislative effort now going forward in this Committee.

The Board has for some years taken the position that our laws regarding financial structure need substantial revision. Developments have significantly eroded the ability of the present structure to sustain competition and safe and sound financial institutions in a fair and equitable way.

Recently, a great deal of attention has been focused, in this Committee and elsewhere, on proposals to permit the affiliation of a broader variety of financial and commercial organizations with banks, while attempting to assure that affiliated banks are not adversely affected by this relationship. Our own analysis of these useful contributions leads us to the conclusion that they have many positive elements that deserve continuing attention, but that it would be appropriate at this time to concentrate on the specific proposal contained in the Financial Modernization Act to repeal the Glass-Steagall Act.

It is our view that enactment of this legislation would respond effectively to the marked changes that have taken place in the financial marketplace here and abroad, and would permit banks to operate in areas where they already have considerable experience and expertise. Moreover, repeal of Glass-Steagall would provide significant public benefits consistent with a manageable increase in risk.

Accordingly, we would suggest that the attention of the Committee should focus on the Glass-Steagall Act and we recommend that this law be repealed insofar as it prevents bank holding companies from being affiliated with firms engaged in securities underwriting and dealing activities. We would not recommend that you address at this time the more generally comprehensive, but in some important ways more limited, approach taken in the very interesting proposals put forward in S. 1891 by Senators Wirth and Graham, about which I will comment in more detail at the conclusion of my testimony.

On the other hand, we very much prefer a full repeal of Glass-Steagall to a piecemeal removal of restrictions on underwriting and dealing in specific types of securities such as revenue bonds or commercial paper. This technique would artificially distort capital markets and prevent financial institutions from assuring benefits to customers by maximizing their competitive advantage in particular markets of their choice.

I. Reasons for Repeal of the Glass-Steagall Act

A very persuasive case has been made for adoption of the repeal proposal. It would allow lower costs and expanded services for consumers through enhanced competition in an area where additional competition would be highly desirable. It would strengthen banking institutions, permitting them to compete more effectively at home and abroad in their natural markets for credit that have been transformed by revolutionary developments in computer and communications technology. It could be expected to result in attracting more equity capital to the banking industry where more capital is needed. In sum, the securities activities of banking organizations can provide important public benefits without impairing the safety and soundness of banks if they are conducted by experienced managers, in adequately capitalized companies, and in a framework that insulates the bank from its securities affiliates.

A. Evaluation Criteria

In reaching these conclusions, we have been guided by the principles set down in the Bank Holding Company Act of 1970 which requires the Board to consider, in determining the appropriateness of new activities for bank holding companies, whether they will produce benefits to the public such as greater convenience, increased competition, or gains in efficiency. It also asks us to evaluate whether these gains may be outweighed by possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

These are the principles that Congress has set down to guide the evolution of the banking system. They made good sense then and they make good sense today. Over the years we have interpreted these principles to be consistent with our efforts to promote competitive and efficient capital markets and to protect impartiality in the granting of credit, to avoid the risk of systemic failure of the insured depository system, and to prevent the extension of the federal safety net to nonbanking activities. In our view, achieving these goals is fully consistent with permitting bank holding companies to engage in securities activities. In short, in my testimony today I will outline why we believe that changes in the Glass-Steagall Act should have major public benefits. I will also explain why we believe that with the right structure and careful implementation, the changes in the law that we support can be accomplished without adverse effects.

B. Public Benefits

The major public benefit of Glass-Steagall modification would be lower customer costs and increased availability of investment banking services, both resulting from increased competition and the realization of possible economies of scale and scope from coordinated provision of commercial and investment banking services. We believe that the entry of bank holding companies into securities underwriting would, in fact, reduce underwriting spreads and, in the process, lower financing costs to businesses large and small, as well as to state and local governments. In addition, bank holding company subsidiary participation in dealing in currently ineligible securities is likely to enhance secondary market liquidity to the benefit of both issuers and investors. These, we believe, are important public benefits that will assist in making our economy more efficient and competitive.

Studies of the market structure of investment banking suggest that at least portions of this industry are concentrated. The most recent evidence in this regard is provided in the September Report of the House Committee on Government Operations, which presented data supporting its conclusion that corporate securities underwriting is highly concentrated. The five largest underwriters of commercial paper account for over 90 percent of the market; the five largest underwriters of all domestic corporate debt account for almost 70 percent of the market; and the five largest underwriters of public stock issues account for almost half of the market.

I would emphasize that concentration *per se* need not lead to higher consumer costs, because the possibility that new firms will enter a market may be sufficient to achieve competitive prices. However, it is just in this regard that the Glass-Steagall Act is particularly constraining, because bank holding companies with their existing expertise in many securities activities and their broad financial skills and industry network more generally, would be the most likely potential competitors of investment banks if not constrained by law.

It is also important to emphasize that the changes in the Glass-Steagall Act that we support would be likely to yield cost savings in local and regional corporate underwriting and dealing markets. At a minimum, local and regional firms would acquire access to capital markets that is similar not only to the access now available to large corporations, but also to that currently available to municipalities whose general obligation bonds are underwritten by local banks.

Another area of substantial expected public benefit is the encouragement of the free flow of investment capital. Both we at the Board and the Congress have stressed the importance of improving the capital ratios of banking organizations, and it can reasonably be assumed that expansion of banking organizations into securities markets should make them more attractive investments. Equally important, banks and securities firms would be free to deploy their capital over a wider range of activities designed to serve the public better.

C. Effect of Computer and Communication Technology

There is another important reason why the Glass-Steagall Act should be changed. Developments in computer and communications technology have reduced the economic role of commercial banks and enhanced the function of investment banking. These permanent and fundamental changes in the environment for conducting financial business cannot be halted by statutory prohibitions, and the longer the law refuses to recognize that fundamental and permanent changes have occurred the less relevant it will be as a force for stability and competitive fairness in our financial markets. Attempts to hold the present structure in place will be defeated through the inevitable loopholes that innovation forced by competitive necessity will develop, although there will be heavy costs in terms of competitive fairness and respect for law which is so critical to a safe and sound financial system.

The significance of these technological developments is that the key role of banks as financial intermediaries has been undermined. The heart of financial intermediation is the ability to obtain and use information. The high cost of gathering and using facts in the past meant that banks and other intermediaries could profit from their cumulative store of knowledge about borrowers by making significantly more informed credit decisions than most other market participants. These other market participants were thus obliged to permit depository intermediaries to make credit decisions in financial markets and therefore allow bank credit to substitute for what would otherwise be their own direct acquisition of credit market instruments.

Computer and telecommunications technology has altered this process dramatically. The real cost of recording, transmitting, and processing information has fallen sharply in recent years, lowering the cost of information processing and communication for banks. But it has also made it possible for borrowers and lenders to deal with each other more directly in an informed way. On-line data bases, coupled with powerful computers and wide-ranging telecommunication facilities, can now provide potential investors with virtually the same timely credit and market information that was once available only to the intermediaries.

These developments mean that investors are increasingly able to make their own evaluations of credit risk, to deal directly with borrowers and, especially with the increasing institutionalization of individuals' savings, creditors are in a position to develop their own portfolios and strategies to balance and hedge risk. Thus, the franchise of bank intermediation, the core element of a bank's comparative advantage, and its main contribution to the economic process -- credit evaluation and the diversification of risk -- has been made less valuable by this information revolution. Examples of new financial products that have resulted from this technological innovation and that challenge traditional bank loans abound -- the explosion in the use of commercial paper, the rapid growth of mortgage-backed securities and the recent development of consumer loan-backed securities or consumer-receivable-related securities. There are many others. Our concern is that these changes in the way that providers of credit utilize financial intermediaries have reduced the basic competitiveness of banks and that the trend toward direct investor-borrower linkages will continue.

D. Banks' Response to New Competitive Conditions at Home and Overseas

Banks, of course, have not stood still while these vast changes were taking place around them. Indeed, they have responded to the technological revolution by participating in it. Loan guarantees and other off-balance sheet arrangements, private placement of corporate debt, commercial paper placement, loan participations and sales, and interest rate and currency swaps are examples. Similarly, the foreign offices of U.S. banks and their foreign subsidiaries and affiliates have been actively engaging abroad in a wide variety of securities activities. These include securities that are ineligible in the United States for banks to underwrite and deal, such as corporate debt and equity. In the corporate debt market, for example, U.S. banks' foreign subsidiaries served lead roles in underwritings approaching $17 billion in 1986, or about 10 percent of the volume of such debt managed by the 50 firms most active in the Eurosecurities market last year. These and other essentially investment banking activities have permitted banks to continue to service those customers seeking to rely increasingly on securities markets -- provided that the securities are issued abroad. In their home market, banks continue to be sharply limited by the Glass-Steagall Act in competing for the business of acting as intermediaries in the process of investors providing credit to corporations, just at the time that the new financial environment transformed by technological change has made such intermediation a natural extension of the banking business.

E. The Need for Reform

In short, Congress should modify the financial structure to conform to these changes. If the Congress does not act, but rather maintains the existing barriers of the Glass-Steagall Act, banking organizations will continue to seek ways to service customers who have increasingly direct access to capital markets. But banking organizations are nearing the limits of their ability to act within existing law; and spending real resources to interpret outmoded law creatively is hardly wise. Without the repeal of Glass-Steagall, banks' share of credit markets is likely to decline -- as it already has in our measures of short- and intermediate-term business credit. Society would lose the existing expertise and infrastructure of banking, and bear the cost of the redeployment of bank resources as personnel and capital move to nonbanking organizations. Instead, a soundly structured change in the law will allow financial markets to serve us better by lowering costs to users while strengthening financial institutions within a framework that will protect the financial integrity of banks.

II. Evaluation of Possible Adverse Affects

The basic principles that I outlined at the outset require us to take into account not only public benefits but also possible adverse effects including unsound banking practices, which clearly include the concept of excessive risk, conflicts of interest, impairment of competition and undue concentration of resources. These concerns have been heightened by the unprecedented stock market decline that occurred on October 19, 1987 and the subsequent market volatility.

A. Effect of Stock Market Developments

We had reached our decision to endorse repeal of the Glass-Steagall Act before these events occurred. When we made our decision we had very much in mind that there are risks involved in underwriting and dealing in securities and we decided that we would recommend the necessary changes only because we believe that a framework can be put in place that can assure that the potential risks from securities activities can be effectively managed. The events since October 19, have not altered our view that it is both necessary to proceed to modernize our financial system and that it is possible to do so in a way that will maintain the safety and soundness of depository institutions.

The preliminary evidence on the limited effects of recent stock market events on securities firms reinforces several conclusions drawn previously. First, while securities activities are clearly risky, the risks can be managed prudently. Second, securities activities of bank holding companies should be monitored and supervised in such a way as to control the risk to an affiliated bank. Third, the events of recent weeks highlight the need to have capital adequate to absorb unexpected shocks and to maintain an institutional and legal structure which minimizes the degree to which securities underwriting and dealing risk could be passed to affiliated banks.

B. Assessment of Risk

Bank holding company examinations indicate that U.S. banking organizations have generally shown an ability to manage the inherent risks of both their domestic and foreign securities activities in a prudent and responsible manner. Of all the domestic bank failures in the 1980s, to our knowledge none has been attributed to underwriting losses. Indeed, we are unaware of any significant losses in recent years owing to underwriting of domestically eligible securities. For that matter, research over the past 50 years concludes, contrary to Congress' view at the time, that bank securities activities were not a cause of the Great Depression and that banks with securities affiliates did not fail in proportionately greater numbers than banks more generally.

The investment banking experience of U.S. banking organizations in foreign markets has been favorable and their operations have been generally profitable in the last decade or so. This is not to say there have been no problems. In the mid-1970s some large U.S. banks encountered problems with their London merchant bank subsidiaries in connection with venture capital investments and the development of the Eurobond market. More recently, in the post Big Bang era, U.S. banks' securities affiliates and subsidiaries have shared in the transitional difficulties that arose in the London securities market. All of these problems appear to have been in the nature of "start-up" difficulties rather than long-term safety and soundness concerns. In these situations, and even in the perspective of the unprecedented stock market decline, risks have been contained and losses have been small relative to the capital of the bank or the holding company parent.

Finally, I would note that empirical studies invariably find that underwriting and dealing are riskier than the total portfolio of other banking functions in the sense that the variability of returns to securities activities exceeds that of the returns to the combination of other banking functions. It is also important to note, however, that the average return to securities activities is also usually found to exceed the average return to the combination of other banking functions. In addition, there is evidence of some potential for limited diversification gains, or overall risk reduction, for banks being allowed increased securities powers.

Congress adopted the Glass-Steagall Act over 50 years ago because it believed that banks had suffered serious losses as a result of their participation in investment banking. Congress also thought that bank involvement in the promotional aspects of the investment banking business would produce a variety of "subtle hazards" to the banking system such as conflicts of interest and loss of public confidence. In answer to these concerns, we believe that the risks of investment banking to depository institutions are containable, that the regulatory framework established in the securities laws minimizes the impact of conflicts of interest, that the federal safety net implemented through deposit insurance and access to Federal Reserve credit will avoid the potential for panic withdrawals from banks if affiliated securities firms experience losses, and that banks can be effectively insulated from their securities affiliates through an appropriate structural framework.

As I have stressed, such an insulating framework can be established. I would now like to turn to what we see as its major elements.

III. Need for Firewalls

Fundamental to our recommendation on repeal of Glass-Steagall, and to our assessment that potential adverse affects of securities activities are clearly manageable, is the view that securities activities can be conducted behind walls designed to separate, in so far as possible, the bank from the risks associated with the securities activities. We see two major elements to an approach toward developing a practical insulating structure:

-- the holding company structure should be used to institutionalize separation between a bank and a securities affiliate, and

-- the resulting institutional firewalls should be strengthened by limiting transactions, particularly credit transactions, between the bank and a securities affiliate.

At the same time, and without impairing the necessary separation, the structure should not be so rigid as to prevent affiliated organizations from providing the users of financial products with the improved service and reductions in cost that can come from the joint ownership of securities and banking organizations. We believe that it is both possible and desirable to accomplish both goals -- establishing fully adequate firewalls in a context that achieves the economic benefits of joint ownership.

It is here that we believe the Financial Modernization Act makes such a major contribution. Using the holding company framework as a focus, it establishes a system of firewalls that we believe is both workable and effective. Because of the importance of these provisions I would like to examine them with you in some detail.

A. Importance of the Holding Company Framework

S. 1886 would require that new securities activities made possible under this bill would have to take place in a subsidiary of a bank holding company, and not in a bank or a direct subsidiary of a bank. We believe that this is a sound decision because it provides the best separation that institutional arrangements can provide between a bank and a securities affiliate. In our judgment, this is the most effective structure for assuring that decisionmaking in securities firms is not affected by the benefits of the federal safety net, for minimizing the need for the regulatory framework that is a necessary consequence of maintaining the safety net, and, of course, for avoiding risks to the safety net itself. Achieving these goals is essential to any plans for permitting broader ownership of banks and wider powers for bank holding companies.

There has not been unanimous agreement on this point and I think it is important to examine the advantages of the holding company approach.

First, there is an important legal reason. The holding company mechanism takes maximum advantage of the doctrine of corporate separateness -- the legal rule that provides that a separately incorporated company normally is not held liable for the actions of other companies even if they are commonly owned or there is a parent-subsidiary relationship. However, because of the direct ownership link between a bank and its subsidiary, any breach of insulating walls is much more likely to result in bank liability for the actions of its security subsidiary because the line of authority to direct operations runs from the bank parent to that subsidiary. The same breach in the wall between a bank holding company and a securities affiliate, on the other hand, is much less likely to involve the affiliated bank simply because of the fact that there is no direct ownership link between the bank and the securities affiliate.

Second, there is a vital point of accounting and resulting market perceptions of the health of the bank. Any losses that may be incurred by the securities firm owned directly by a bank would be reflected in the balance sheets and income statements of the bank under normal accounting rules.

That would not be the case if the holding company owns the securities affiliate directly. Where a securities firm's losses are reflected directly on the financial statements of the bank, the markets' evaluation of the health of the bank will inevitably be adversely affected.

Third, it is difficult, if not impossible from a practical standpoint, for a bank to avoid assuming responsibility and liability for the obligations of its direct subsidiaries. Experience has shown that the direct ownership link between a bank and its subsidiaries creates a powerful public perception that the condition of the bank is tied to the condition and financial success of its subsidiaries.

Fourth, separation of a bank and an affiliated securities firm through a holding company helps promote competitive equity. Securities activities that are conducted directly within a depository institution or in a subsidiary of a depository institution are much more likely to benefit from association with the federal safety net through increased public confidence in securities offerings made by the insured banks and their subsidiaries than would be the case if these activities were conducted in a holding company affiliate. Similarly, the holding company technique would be more effective in minimizing any competitive advantage banks would have in raising funds because of their association with the federal safety net and their ability to collect deposits.

Thus, we believe the advantages of the holding company structure are both self evident and overwhelming. Larger banking companies that are most likely to be heavily involved in securities activities should have no serious organizational problems with implementing this approach.

For the smaller banking firms that do not have holding companies, the bill has two constructive solutions. First, to ease the regulatory and cost barriers to the establishment of holding companies, section 201 provides for expedited, almost automatic, Board approval of applications to form such holding companies, and section 202 allows such formations that are simply reorganizations without a change in ownership to be exempt from securities act registration. Second, the bill allows banks to continue to conduct presently authorized securities activities and also permits them to engage in underwriting municipal revenue bonds and brokerage of mutual funds. We understand the SEC's concerns about assuring that functional regulation prevails in this area, and we believe that consistent with appropriate exceptions for small banks, these problems are resolvable.

IV. Strengthening Holding Company Firewalls

The second major element of the separateness structure is to assure that the holding company firewalls are not impaired by transactions between a bank and an affiliated securities firm, with the consequence of the risks of securities activities being passed on to an affiliated bank. We believe that section 102 of S. 1886 is fully adequate to do this essential strengthening job. It clearly addresses the key issues of:

- interaffiliate credit transactions and guarantees,
- lending to support underwritten securities,
- officer and director interlocks, and
- adequacy of disclosure and other conflict of interest problems.

A. Prohibition on Lending by Bank to Securities Affiliate

In reviewing these firewall strengthening measures, we consider one of the most important and difficult to be the prohibition on a bank being able to lend to or purchase assets from its securities affiliate. There are strong arguments on both sides. In formulating our position on this issue we took into account the major advantages of a straightforward prohibition on lending to securities affiliates thus insulating the bank from the risks of securities activities, and weighed against it the benefits that could be achieved in terms of better service to customers.

We also considered that rules now exist limiting the amount of credit that a bank can provide to an affiliate and that require that this lending be at arms-length and adequately collateralized. Our experience indicates, however, that these limitations, embodied in sections 23A and 23B of the Federal Reserve Act, do not work as effectively as we would like and, because of their complexity, are subject to avoidance by creative interpretation, particularly in times of stress.

On the other hand, we came to the conclusion that a prohibition on an affiliated bank's loans to, and purchases of assets from, its securities affiliate would sharply limit the transfer of the risk of securities activities to the federal safety net. It would also eliminate one of the key factors viewed by the courts as justifying "piercing the corporate veil" between the bank and its nonbank affiliates -- that operations of the securities affiliate are financed and supported by the resources of an affiliated bank. For these reasons, and because of the desirability of having a clear rule that is not subject to avoidance, we agree with the provisions of section 102 that prohibit banks from lending to, or purchasing assets from, their securities affiliates except for collateralized lending for intra-day government securities clearing.

We also agree, as allowed by S. 1886, that a securities affiliate should be free to borrow from its holding company parent. The holding company is not protected by the federal safety net and competitive fairness requires that the parent of a securities affiliate should be able to support its affiliate in the same manner as the corporate parents of investment firms that are unaffiliated with banks.

B. Other Transaction Limitations

For very similar reasons we agree, as provided in section 102, that a bank should not be able to guarantee, extend its letter of credit to, or otherwise support securities issued by a securities affiliate. Allowing such practices would not only raise the question of competitive fairness, but also would permit a transfer of the risks of securities activities to the federal safety net. This section would also prevent, during the underwriting period and for 30 days thereafter, loans from a bank affiliate to customers for the purpose of buying securities underwritten by a securities affiliate. Finally, it would stop loans from affiliated banks to companies whose securities have been underwritten by a securities affiliate for the purpose of repaying interest or principal due on such securities. We agree that these prohibitions are essential to establishing sound firewalls.

C. Preventing Conflicts of Interest -- Disclosure

Another major purpose of firewalls is to prevent conflicts of interest that can impair confidence in banking institutions. The disclosure requirements and other provisions of the securities laws already have made an effective contribution to dealing with this issue. Nevertheless, we welcome the strengthening of these already built-in protections by the provisions of section 102 which require, under rules established by the SEC, a securities affiliate to disclose its relationship to an affiliated bank and to state plainly that the securities it sells are not deposits and are not insured by a federal agency.

D. Officer and Director Interlocks

The prohibition in section 102 on officers and directors of a securities affiliate serving at the same time as an officer or director of any affiliated bank is also important to maintaining the principle of corporate separateness and to avoiding conflicts of interest. For this reason we are somewhat concerned about the complete exemption in this section from this limitation for banks with total assets of $500 million or less. In order to permit the operating efficiencies that smaller banks may achieve from using common management officials without severely eroding the corporate separateness of the bank, we recommend that these banking organizations be permitted to have interlocking officials with a securities affiliate, but be required to maintain a majority of the board of directors of the securities affiliate that are not also directors of the banking organization.

E. Other Conflict of Interest Safeguards

In addition, S. 1886 reinforces the requirements of existing law by providing that a securities affiliate cannot sell securities from its portfolio to an affiliated bank at any time, or place securities with its trust accounts during an underwriting period or 30 days thereafter. S. 1886 also helps to assure objectivity where a securities affiliate underwrites securities originated by an affiliated bank by a requirement that those securities must be rated by an unaffiliated nationally recognized rating agency. Finally, we note with approval that under the bill neither banks nor their securities affiliates would be able to share confidential customer information without the customer's consent and that a bank cannot express an opinion on securities being sold by its securities affiliate without disclosing that its affiliate is selling that security.

F. Capital Adequacy

We believe that the firewalls that are established by S. 1886 will substantially augment the existing insulation of banks from affiliates that is now provided by the Bank Holding Company Act. In addition to these measures, perhaps the best insulator is adequate capital for both banks and securities affiliates.

Accordingly, authority should be provided to assure that holding companies owning banks and securities companies should be adequately capitalized. Consequently, we fully support the provisions of section 102 which require that investments by bank holding companies in securities firms should not be permitted if the investment would cause the holding company to fall below minimum capital requirements.

Moreover, to assure that a banking organization's securities affiliate is regulated as to capital adequacy in the same manner as other securities firms, section 102, in calculating the capital adequacy of a bank holding company that acquires a securities firm, excludes from the holding company's capital and assets any resources of the holding company that are invested in the capital of the securities affiliate. We agree that the investment of a holding company in its securities subsidiary may be deducted from the capital of the bank holding company in determining its capital adequacy. Such deductions should include any asset of the holding company that is considered capital in the securities subsidiary by its functional regulator.

However, in calculating the regulatory capital for the holding company, S. 1886 would deduct from the assets of the holding company all loans to the securities subsidiary, and thus the holding company would not be required to hold capital to support these assets. We feel that any holding company advances to a securities affiliate that are not considered capital by the functional regulator should not be deducted from the holding company's assets and capital. Rather, they should be supported by capital at the holding company, just as advances to other subsidiaries require capital support.

To do otherwise would be to promote unlimited leveraging in the holding company, thereby weakening or eliminating the ability of the holding company to act as a source of strength to its subsidiary banks. With this modification, section 102 would not only assure that the securities affiliate broker-dealer will be regulated as to capital adequacy by the SEC, but would also have the beneficial effect of requiring a bank holding company to maintain capital sufficient to absorb losses suffered by the securities affiliate without impairing the holding company's ability to serve as a source of strength to its bank subsidiaries. This result is consistent with the provisions of section 102 which provide that the Board can reject a notice to establish a securities affiliate if it would be inconsistent with a bank holding company's obligation to serve as a source of strength to its subsidiary banks.

G. Support for Functional Regulation

At this point I believe it would be appropriate to stress the full support of the Board for the concepts of functional regulation incorporated into S. 1886. We agree that a securities subsidiary of a bank holding company carrying out the functions of a broker-dealer should be subject to the net capital requirements of the SEC and should, indeed, be regulated by that body once it has been established.

As I have stressed, however, we do believe that there is a proper role for regulation of a company that owns a bank. As provided under current law, a company that owns a bank should have competent management, should be adequately capitalized, and should be open to review in as unobtrusive a manner as is possible consistent with achieving these goals.

This position is consistent with our support for the provisions of section 102 which exempt a securities firm that owns a bank from normal holding company capital and examination requirements if at least 80 percent of its assets and revenues are derived from, or devoted to, securities activities. Even in this situation, S. 1886 does not ignore the importance of capital. If an exempt company's bank falls below minimum capital levels, the Board can require restoration of minimal capital levels within 30 days, and in the absence of compliance can order the termination of control within 180 days. In the context of the situation where a firm is overwhelmingly a securities firm, this framework has our full support. This is a unique provision that may, if it works successfully, provide a precedent for developing the complex of measures that are needed in order to allow broader ownership of banks and to protect the federal safety net.

We also support minimizing regulatory burdens wherever possible. Accordingly, we endorse the provisions of Title II generally on "Expedited Procedures" and, particularly, section 203 of the bill which speeds up the holding company applications procedure for approved holding company activities by changing it into a no objection arrangement and by eliminating the cumbersome requirements for formal hearings. We also endorse the provisions of the bill which allow the Board to take into account technological or other innovations in the provision of banking or banking related services in making judgments on whether an activity is so closely related to banking as to be a proper incident thereto. We believe that these provisions, which have had the Board's support for a number of years, will reduce regulatory burdens and introduce needed flexibility into the regulatory process.

The **Chairman**. Well, thank you very much, Chairman Greenspan, for what I think is a very comprehensive, detailed, excellent analysis of the bill. I think you've met a number of the objections which people would feel about repealing something that has persisted as long as Glass-Steagall and had very legitimate justification at the time it was adopted.

UNDERWRITING SECURITIES BY BANKS

Mr. Chairman, it's often claimed that permitting banks to underwrite securities is dangerous. They claim that banks illustrated that problem with what happened in the 1920's.

Do you agree that the 1920's experience is an instructive example for the present?

Mr. **Greenspan**. I think that history is always useful, but as best we can judge, the evaluation of the dangers of underwriting in that period was probably exaggerated and surely it did not have the effect on the break in 1929 that occurred in the economy. It's very difficult to get exact evaluations, but in retrospect, the most thoughtful people looking at that period have concluded that underwriting was not a dangerous activity. The problems that surfaced collateral to that have been taken care of in the Securities Act of 1933, and what problems would exist in underwriting that existed back then are now prohibited by law by the Securities Act.

The **Chairman**. Are you saying that the abuses were not confined to banks, that there were also abuses that securities firms engaged in and that the reforms that we had and the creation of the SEC and so forth have largely remedied those abuses?

Mr. **Greenspan**. Yes, Mr. Chairman.

The **Chairman**. Now why do you believe that the holding company structure is a sounder approach to increasing the securities powers of banks than the subsidiary approach, having the bank own the securities firm?

Mr. **Greenspan**. Well, Mr. Chairman, as you know, this is an issue, that has created a good deal of debate amongst a number of analysts of banking structure. It is our view that it is essential to insulate the securities affiliate as much as possible from the banking organization.

In our view, if you make the securities affiliate a subsidiary of the bank, you essentially are creating a problem which makes it very difficult to insulate the activities of that securities affiliate.

Essentially, the problem really gets down to the question of the lending or any endeavor of the commercial bank to assist the securities affiliate. And should it do so, it would conceivably break down the corporate veil in a manner which would make the bank vulnerable to activities, losses, and other actions that the securities affiliate would be engaged in.

Also, because of the fact that the commercial bank would consolidate the income of the securities affiliate in the commercial bank—since securities income tends to be somewhat more volatile than banking-type income—it would create a distortion in the bank's accounts which I don't think is terribly helpful.

The most important issue, however, is that if we place the securities affiliate under the holding company, then all actions, all assistance to the securities affiliate, can occur directly with the holding company. And it's our view that there is no useful purpose served in making a securities affiliate a subsidiary of a bank.

The CHAIRMAN. Now some members of the securities industry have argued that in the wake of the recent turbulence in the stock market that now is not the time to be talking about new securities powers for banks. They argue that the securities business is a lot riskier than the banking business, that we should continue to keep these two industries separate.

What's your response to these arguments and do we weaken the safety of our banking system if we allow banks to be affiliated with securities firms?

Mr. GREENSPAN. Well, first of all, Mr. Chairman, it is certainly the case, as I mentioned before, that the volatility of income in a securities affiliate is greater than in a commercial bank. But also, the average level is significantly higher and, as a consequence, on average, we don't believe that placing the securities affiliate with a commercial banking holding company is a particular risk, provided that there are sufficient firewalls constructed.

The issue of what banking structure should be, in my judgment, should not be reflective of what particular period we are looking at. This is an issue which is a long-term structural question of banking. I don't think that one should be concerned about short-term effects because what one is planning for, what one is legislating for, is the longer-term future.

I don't particularly think that the evidence suggests at all that what banks and securities firms were engaged in in the most recent weeks in any way says to me that there is any reason at this stage not to move forward with this legislation.

On the contrary, even though the Federal Reserve Board agreed on the particular support that we give to your legislation prior to October 19, we did review it again subsequently and found no reasons to make any changes in our recommendations.

The CHAIRMAN. Thank you, sir.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

In attempting to draft this legislation and allowing commercial banks to affiliate with securities firms, one of the concepts that I have always supported is functional regulation.

It seemed to me over the years that no matter what we did in terms of allowing banks into various securities powers, whether it was the four that we talked about for so many years, that it still wasn't fair and it wasn't equitable unless those particular services or products were regulated in the same manner. In other words, banking functions ought to be regulated by banking regulators and securities functions by the SEC or securities regulators.

Do you support the concept of functional regulation?

Mr. GREENSPAN. Yes, I do, Senator.

Senator GARN. Do you believe that Fed regulation of a holding company that has a bank subsidiary or a securities subsidiary is necessary? This gets into this argument now of what we're doing here, trying to separate—you've got a holding company that will own both the bank and a securities firm—how we handle that separation without intruding the banking regulation under the Bank Holding Company Act too much into the securities affiliate.

Mr. **Greenspan**. Senator, I would never say in restructuring the banking system that any particular form is necessary, mandatory, and something we cannot do without.

I would nonetheless say it is by far the most preferable structure. Although I recognize that there are other potential structures, from what I've been able to see, looking at various structures, the bank holding company structure strikes me as the most sensible and most immediate mechanism which solves a number of the problems that could exist in endeavoring to bring securities and banking affiliates together.

Senator **Garn**. Over the years, it seems as if every time we get close to legislation, for those who oppose any change whatsoever, there always appears to be something that comes up just at the right time for them to use for a reason why we should not do anything. Obviously, the recent October 19, is one of those. It falls right into their hands and whether it makes any sense or not, it's convenient for them to use.

But even more specifically, the opponents have argued that the experience with First Options in Chicago supports their arguments against making any change.

THOUGHTS ON FIRST OPTIONS SITUATION

What should we learn from the First Options situation in Chicago and what's your opinion of that situation relative to what we are doing with this legislation?

Mr. **Greenspan**. Well, Senator, the chairman has requested that we answer a number of questions and we will have an answer to the committee in some detail in writing on that particular issue.

What basically happened was the type of thing which one would expect to occur to one or two or maybe more types of institutions when one is confronted with such an unprecedented change in the financial markets. I think that the issue was basically contained. I don't think that there was a particular problem created with respect to the overall financial system.

There was a difficulty in which First Options borrowed from Continental Illinois Bank over its limit as required by the Comptroller of the Currency. Within 24 hours it was recognized that that was an improper action. It was reversed and the proper action in that case—that is, additional assistance coming from the holding company to First Options—was then initiated.

I suspect that were not the mistake made—and it was a mistake—I doubt very much whether or not it would have gotten the publicity that it subsequently got.

Senator **Garn**. Mr. Chairman, again, the argument of the opponents is almost always safety and soundness. They are so incredibly concerned about safety and soundness, and yet, at the beginning of the 1980's there was a tremendous outflow of capital that was taking place from traditional depository institutions because of the new type of accounts that were available paying market rates, and we had regulation Q still on the books—looking at that situation, as a matter of fact, there were hundreds of billions of dollars

V. Coordinated Activities

With the strong system of firewalls that are contained in S. 1886 in place, we believe it is appropriate to allow the joint banking-securities enterprise the opportunity to realize the efficiencies that may be achieved by combining services that are functionally so closely linked. After all, one of the major purposes of allowing the affiliations that could be established by repealing Glass-Steagall is to permit, in a competitively neutral manner, the users of securities services to benefit from a higher level of competition. Thus, in our view, the approach taken in the bill of permitting use of similar names and coordinated marketing of products is appropriate. We believe that a prohibition on these activities would produce only small gains for bank insulation, but the losses to efficiency would be high.

The requirement of separate names would be artificial particularly because securities law disclosure would, in any event, require an affiliate to inform the users of its services of its association with a banking enterprise. Similarly, as I pointed out earlier, the market for securities is only an extension of the market for other banking products and to deny a banking organization the ability to sell both products would lose much of the gains for the economy that we seek to achieve through the association between the two. Moreover, there would be no competitive unfairness in this arrangement since the broad relaxation of the Glass-Steagall requirements that is proposed by S. 1886 would enable securities firms to own banks as well as bank holding companies to own securities affiliates.

The important point is whether these measures would cause the risks of securities activities to be passed on to banking institutions and to the federal safety net. As I indicated, the Board believes that the corporate separateness measures that we recommend, and that have been adopted in S. 1886, should effectively deal with these problems.

VI. Concentration of Resources

The guidelines Congress has established for expansion of banking activities require a concern for whether expansion of securities powers will lead to a concentration of resources in the securities or banking industries. We believe that repeal of Glass-Steagall should have the opposite effect. As I have stressed today, it will increase the number of viable competitors in both the banking and securities industries, enhancing competition in both. As a result, we doubt that the Congress need go beyond the requirements of the antitrust laws to anticipate a problem with concentration of resources in the emerging financial services industry. However, because we see as one of the major advantages to repeal to be an expected increase in competition, and because we could understand anxieties that this goal might be impaired by a combination of the largest banking and securities firms, the Board does not oppose the limited provisions of section 102 of S. 1886 aimed at preventing the largest banking and securities organizations from consolidating.

VII. Comments on S. 1891 -- The Financial Services Oversight Act

The Financial Modernization Act deals with the problems of our financial system by focusing on the specific question of securities powers, an area which is of great importance to the financial system. While it sets up a framework which could be used as a precedent for the consideration of other products and services, it does not deal with those issues at this time, leaving this question open for further consideration in the future. We believe this is the right way to proceed at this time.

A different approach has been taken by S. 1891, the proposed Financial Services Oversight Act introduced by Senators Wirth and Graham, which establishes a comprehensive framework for the conduct of the financial services business in the United States. As a first step toward this objective, the bill establishes a Financial Services Oversight Commission, with a membership drawn from the banking agencies, the SEC, the CFTC and the state insurance commissioners. This broadly based Commission would have three essential functions: (a) it would define the types of activities in which bank holding companies, financial holding companies, and commercial holding companies could engage; (b) it would be charged with enforcing compliance with the regulations defining new activities; and (c) it would establish minimum standards of capital adequacy for financial holding companies and their affiliates.

Fundamental to this approach is a broad expansion of the financial activities in which bank holding companies may engage, including an explicit repeal of the Glass-Steagall Act. The bill also provides for the extension of a limited degree of prudential regulation to financial holding companies, which are companies that include affiliates that offer uninsured transaction accounts, to include capital adequacy standards as well as reserve requirements. Also fundamental to this concept is the separation of banking and commerce by providing that a commercial holding company cannot own a bank that offers federally insured deposits.

The third major element of the bill is the establishment of a National Electronic Payments Corporation for the purpose of operating a mixed public/private corporation that would establish and operate a national electronic payment system to facilitate large dollar transactions, including book-entry transfers of U.S. government securities. The Corporation would also be responsible for the establishment of standards for utilization of this system and for improvements in the technological capability and reliability of the system as a whole. This enterprise, capitalized with funds from the Federal Reserve System and by the private shareholders, would provide for direct access to the system not only by banks, but also by other financial organizations which have transactions in funds and government securities of a magnitude sufficient to make their participation as shareholders in the new corporation appropriate.

The Board finds this proposal to be a careful and very thoughtful approach to the difficult problems that this Committee is attempting to grapple with today. As Senator Wirth pointed out in introducing S. 1891, the bill incorporates a proposal made by Federal Reserve Bank of New York President Gerald Corrigan and thus the Board is fully familiar with both its structure and objectives.

A. Desirability of Coordinated Regulation

One of the proposals in the bill that we find to be particularly useful is the provision on establishing a Financial Services Oversight Commission to bring together the various regulatory interests that affect our highly integrated financial mechanism. The need for greater regulatory coordination could not have been brought out more clearly than in the recent stock market developments where we saw the complex interactions of securities, commodities, and banking markets.

Similarly, I have emphasized in my testimony today that securitized products are a natural extension of the market for banking activities, but at this point it is also important to stress that securities firms have undertaken many of the activities that have been traditionally thought of as unique to banking. Again, we have examples in the news, such as bridge lending, but there are many others as well, including foreign exchange transactions and the offering of transaction accounts.

These overlaps in functions suggest not only that rigid lines between providers of securities and banking services are impractical, but also that more coordination of regulatory activities is highly desirable. For example, as we seek to establish a worldwide risk based capital system for banking organizations that will apply capital standards to a considerable variety of now off-balance sheet activities, our ability to do so, and the stability of markets, will be adversely affected if almost identical activities of securities firms are not subject to the same type of capital adequacy requirements. Thus, a broadly representative financial regulatory body with adequate authority to coordinate financial regulation needs careful consideration as the Congress makes the essential changes necessary to adapt the financial system to the new realities of competition and technology. We urge that further thought should be given to how this approach could be integrated with S. 1886.

B. Concerns about the Authority of the FSOC

We are concerned, however, about taking the Financial Services Oversight Commission concept further at this time by establishing separate categories of bank, financial, and commercial holding companies, together with authority in the Commission to fix the activities of each type of institution. This format may be too rigid, and the bill does not give the Commission specific enough instructions as to the basis for its decisions, nor do we believe that it is possible now for the Congress to write the needed comprehensive instructions. For example, no guidance is provided on the firewalls to separate banking and nonbanking activities that the Board considers to be essential to an adequate framework for expanded activities of companies that own banks.

Rather, it seems to us that there are major advantages to proceeding on an incremental basis starting with securities powers where the rationale for change has been clearly established. In this way, we can have the benefits of change while gaining experience with the systems that are necessary to assure that this change is carried out in a responsible and effective manner. As conditions evolve over time, a more flexible structure will allow both the Congress and the regulators the opportunity to be more responsive to the needs of customers and less dependent on rigid formulas that may not be practical.

C. National Electronic Payments Corporation

Finally, we have given considerable thought to the concept of a National Electronic Payments Corporation. There is much to be said for its emphasis on spurring technological improvements, on arrangements for liquidity reserves to protect the integrity of that system, and on limiting intra-day overdrafts. However, we are not sure that the mechanism proposed in the bill is the most efficient and cost effective way of achieving its worthwhile goals. The issues that it raises warrant further study.

VIII. Application of S. 1886 to Savings and Loans

Finally, I would like to note that S. 1886 does not apply to savings and loan institutions or their holding companies. However, it would seem appropriate that the framework that is being developed by this Committee for the proper conduct of securities activities to protect the federal safety net, to prevent conflicts of interest, and to assure competitive equality within a structure of functional regulation, should be equally applicable to these institutions. We understand, however, the concerns about the effect of these rules on the possible willingness of securities firms to put capital into troubled S&Ls at a time when the industry and its regulators are attempting to deal with large losses in a considerable number of institutions.

Thus, the Congress has to reconcile conflicting public policy objectives -- the need to deal with present losses in a constructive way, while at the same time to protect the future health of depository institutions when engaging in a new activity. I have no easy answers to this dilemma, except to suggest that it be kept under review so that this Committee can work, in close consultation with the FHLBB, on such ideas as transition periods, exceptions for capitalization of large troubled institutions, or other solutions that the legislative process is uniquely capable of working out.

* * * * *

We commend this Committee for its active role in considering one of the most important issues that now faces our financial markets. We strongly recommend that you adopt legislation to repeal the Glass-Steagall Act and to put in its place a new framework allowing the affiliation of banking organizations and securities firms as provided in the Financial Modernization Act proposed by Chairman Proxmire and Senator Garn.

We also urge you to allow the moratorium on banking activities contained in Title II of CEBA to expire on March 1, 1988, as the law now provides. We believe that these measures will ensure a more responsive, competitive and safe financial system.

that flowed out. And when we were able to reverse that, the money flowed back in when we allowed banks to pay interest on checking accounts and pay market interest rates.

My point is, I believe that the safety and soundness argument can be made in the other direction; that if we do not allow banking institutions to compete, that we endanger their safety and soundness and their profit and their viability. And I think there is all kinds of evidence over the last 6 or 8 years particularly that proves that.

Would you agree that, rather than endangering traditional depository institutions by expanding their powers and ability to compete, that it could do just the opposite and make them stronger and more profitable and less drain on the insurance funds if they are profitable?

Mr. GREENSPAN. I would agree with that, Senator. In fact, I was first concerned about this whole issue largely because of the evidence which continued to mount that under existing legal structures the technology that is emerging—irreversible technology—is gradually dissipating the key intermediation process of the commercial banking system.

To the extent that technology has sharply lowered the cost of credit information, it, of necessity, weakens any institution which is endeavoring through a depository structure to function in a safe and sound manner.

As a consequence of that, I am of the opinion that if we do nothing—that is, if we keep the existing rigid regulatory structure, very specifically the Glass-Steagall barrier between banking and securities—that we will gradually erode the commercial banking function. And in that process, as we find in all declining economic phenomenon, safety and soundness gets undercut.

So in my view, I believe that it is essential that we eliminate this barrier if our purpose, as you point out, is safety and soundness. And I would think that unless we are willing to restructure in this manner, we are going to find ourselves with institutions which are going to be very difficult to deal with.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Riegle.

Senator RIEGLE. I assume that in your mind if we were to adopt this proposal as you've described it here today that not all banks would choose to go into the securities business, that some would and presumably a vast number of the banks in the country would not. Is that your supposition?

Mr. GREENSPAN. I think that's probably correct, Senator.

Senator RIEGLE. So I assume also then, that the theory is that this has something to do with size, that banks of a certain size or certain geography need to be in the investment banking business whereas banks of a different size and different location and different character may not be as relevant to them. Is that implicit in that?

Mr. GREENSPAN. No, I wouldn't say that at all. On the contrary, I think that one of the areas that are likely to be tapped if this legislation is passed is the need for securities services of a lot of medium size and medium small corporations who, because of their size, are unable to access the large investment banking firms in the Wall Street area, so to speak.

I would think that should regional banks or small banks or even community banks have these powers, what they will find is that there is an evolving potential market for securities underwriting which they will be able to do on a competitive basis for their local companies, their regional industries, in a way which I don't think are currently being appropriately serviced by the investment banking community.

Senator RIEGLE. So if I may just state, it sounds to me like what you're saying is that over time, if we were to go down this road, you see a situation where corporate borrowers would not necessarily be coming to Wall Street investment banking houses to do that function, but what you might actually have grow up across the country is sort of a regionalized or decentralized new kind of investment banking operation of a smaller scale done under this new kind of bank holding company umbrella. Is that right?

Mr. GREENSPAN. Yes, Senator. I don't want to forecast that this is a major change. What I am saying, however, is that individual smaller banks that are looking for new services to offer to their local area are going to find that rather than make regular commercial loans they are going to find that the offering of either a commercial loan or some form of security to a local industry is going to create a better service for that customer and a better customer for that bank holding company.

Senator RIEGLE. Well, that starts at some point to get into the tie-in relationship, which you mentioned you're concerned about, so it's not as if you can actually take the fellow and steer him over to your securities affiliate. You're not suggesting that.

Mr. GREENSPAN. You've got to be very careful about tie-ins, but I think joint marketing would be appropriate.

Senator RIEGLE. Let me ask you this. Do you then envision under the proposal that you've laid out today that all of the securities functions that are now found in banks would be taken out of the banks and put over into the securities affiliate—brokerage services and things of that kind? Would you unbundle all related securities activities and take them over to the new affiliate?

Mr. GREENSPAN. That is a decision that the committee has to make and the Congress has to make. I can't offer any particular recommendation on that because currently I would think that a goodly part of the activities that are now within the bank are appropriately there and I have no strong feelings what ultimately should be done in that respect.

Senator RIEGLE. I'm a little bit surprised at that answer. I mean, it seems to me that if you're going to set up a securities affiliate that you're going to have devoted to that kind of activity, there's a certain neatness of regulation and a certain neatness of this functional division that you speak of to have it all sort of in one place rather than spread across two places.

Mr. GREENSPAN. I understand that and I think that this is an issue which has got to be refined when we get down to the key question of functional regulation, and I see no particular problems in resolving this in a way which in fact makes it symmetrical and fair. The specific individual cases are something which the committee will want to look at. But the principle as stated, recommendations from the SEC and ourselves, will probably be forthcoming which will give you considerable detail on what might be appropriate in that type of structure.

Senator RIEGLE. Just one other brief question at this point. What do you envision in your own mind as being a sufficient penalty structure? I mean Chinese walls, firewalls, these airtight compartments—we've tried to do that in a lot of different situations. They are not easy to do and they are penetrated by fraud and people and so forth.

What do you envision as a structure of penalties sufficient to really create such a powerful disincentive that it minimizes it and what do you do to the person who does cheat?

Mr. GREENSPAN. Well, that's an issue for dealing with felonies. I'm not an expert in that field but I would say that the penalties should be adequate to restrain the offense.

Senator RIEGLE. Well, perhaps we can come back to that.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Greenspan, again, thank you for being here.

If I might, Mr. Chairman, will you include in the record the piece by James Stewart and Daniel Hertzberg from the Wall Street Journal of Friday, November 20, at the appropriate spot in the record?

The CHAIRMAN. Without objection, so ordered.

THE WALL STREET JOURNAL FRIDAY, NOVEMBER 20, 1987

Terrible Tuesday

How the Stock Market Almost Disintegrated A Day After the Crash

Credit Dried Up for Brokers And Especially Specialists Until Fed Came to Rescue

Most Perilous Day in 50 Years

By JAMES B. STEWART
And DANIEL HERTZBERG
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK—A month ago today, the New York Stock Exchange died. But within an hour or two, it was raised from the dead.

The previous day, Oct. 19, when the Dow Jones Industrial Average plunged 508 points in history's largest one-day loss, has been dubbed Black Monday. But it was on Tuesday, Oct. 20, that the stock market—and by extension all the world's financial markets—faced one of their gravest crises.

Full details of what happened that fateful week are only now emerging and are the subject of major inquiries by a presidential commission, congressional committees and others. But minute-by-minute scrutiny of the events of that Tuesday, plus scores of interviews with key stock, commodities and futures market participants, the Federal Reserve, and investment and commercial bankers, reveals that:

—Stock, options and futures trading all but stopped during a crucial interval on Tuesday. Many major stocks, such as International Business Machines Corp. and Merck & Co., couldn't be traded. Investors large and small couldn't sell their stock; there were no buyers. The industrial average was meaningless because many of its component stocks weren't trading. The Big Board's market makers, or specialists, were overwhelmed by unfilled sell orders, and their capital was devastated.

—Many banks, frightened by the collapse in prices of stocks that were collateral for loans to securities dealers, refused to extend sorely pressed dealers any more credit. They also called in major loans, imperiling some securities firms.

—Some big investment-banking firms, facing catastrophic losses if the market panic continued, urged the New York Stock Exchange to close.

—Only the intervention of the Federal Reserve, the concerted announcement of corporate stock-buy-back programs, and the mysterious movement—and possible manipulation—of a little-used stock-index futures contract saved the markets from total meltdown.

The story of that Tuesday discloses major weaknesses in the U.S. financial system and raises the specter that such a crisis could strike again. "Tuesday was the most dangerous day we had in 50 years," says Felix Rohatyn, a general partner in Lazard Freres & Co. "I think we came within an hour" of a disintegration of the stock market, he says. "The fact we didn't have a meltdown doesn't mean we didn't have a breakdown. Chernobyl didn't end the world, but it sure made a terrible mess."

* * *

Monday, Oct. 19, 11 p.m. This day was the worst in Wall Street's history—and worst of all for the Big Board's specialists. The specialists, more than 50 little-known but powerful firms, are required by Big Board rules to buy and sell assigned stocks during volatile times to keep prices as orderly as possible. They usually profit handsomely by shrewd trading—a franchise that has long been the envy of large, publicly oriented securities firms prevented by Big Board rules from becoming specialists themselves. Specialists are supposed to provide the last bastion of liquidity; in normal times, they are the reason an investor can buy or sell a stock when no other investors are in the market. On this day, at least, they were clearly not up to the task.

As the market plunged on Monday, the specialists bore the brunt of the fall. "From 2 p.m. on, there was total despair," says James Maguire, the chairman of Henderson Brothers Inc., a big specialist firm that makes markets in about 70 stocks. "The entire investment community fled the market. We were left alone on the field." Forced to buy stock himself when there were no other buyers, Mr. Maguire ended the day with $500 million in stock—three times his normal inventory. Like other specialists, he had to pay for this stock five business days later, the following Monday. To do so, he would have to borrow.

Mr. Maguire phoned his bank, Bankers Trust Co., one of New York's biggest and an important lender to Wall Street. He asked for a $30 million loan, even though Henderson is one of Wall Street's best-capitalized specialist firms. He was stunned by the response. "They stated they were in no position to make commitments," Mr. Maguire says.

Mr. Maguire phoned the bank five times between 11 p.m. and 12:30 a.m. It wouldn't budge.

Other specialists report similar experiences. One, A.B. Tompane & Co., similarly turned down by Bankers Trust, was hurriedly forced into the arms of well-capitalized Merrill Lynch & Co. The two firms shook hands on the merger at 3 a.m. By dawn, nevertheless, the worst was yet to come for the markets.

Tuesday, 6:30 a.m. Big Board Chairman John J. Phelan met a neighbor going down in the elevator of his Manhattan apartment building. The neighbor was concerned not about Monday's 508-point plunge but about rumors that the Big Board might close. "He said, 'My God, if things were bad enough to close the market, things were really bad,' " Mr. Phelan recalls.

Tuesday, 8 a.m. Bank credit is the lifeline of Wall Street securities firms, and specialists weren't the only ones rushing to arrange more of it Tuesday morning. Large securities firms had swollen stock inventories, accumulated to accommodate major clients who wanted to sell, or in some cases held as part of the firms' holdings of stocks they expected to be involved in takeovers. Demand for credit was further fueled by an explosion of trading in the government-securities market. Trading by big government-securities dealers surged by $58 billion to a daily average of $173 billion that week. In addition, arbitragers, who had accumulated billions of dollars of takeover stocks, were also getting squeezed by margin calls.

The big firms fared little better. Phone calls started pouring into officials at the Big Board and the Federal Reserve Bank of New York. Angry securities dealers reported that foreign and U.S. regional banks were cutting back credit to the securities industry. Bankers Trust told Wall Street firms that it would stop extending unsecured credit—loans not collateralized by assets.

Executives at one big Wall Street securities firm were shocked when another U.S. bank Tuesday refused to deliver promptly $70 million in West German marks that it had sold to the firm in a foreign-exchange trade. Apparently, the bank feared that it might not be paid promptly—if at all—for the marks. Securities firms "were beginning to have trouble getting extended credit," Big Board Chairman

Phelan says. "Japanese banks threatened to stop" lending, adds the head of one of Wall Street's largest securities firms.

Tuesday, 9 a.m. As the credit markets came to life in the U.S., Federal Reserve officials were swinging into action. In the early-morning hours, from a hotel room in Dallas, Chairman Alan Greenspan had decided to issue a one-sentence statement that in effect would reverse the course of policies that he had set into motion upon taking office two months before. He canceled a speech and headed back to his Washington office.

Meanwhile, E. Gerald Corrigan, the beefy president of the Federal Reserve Bank of New York and a protege of Mr. Greenspan's predecessor, Paul Volcker, was in close touch with the stock exchanges—due to open in half an hour—the banks and the bond market. As the head of the Federal Reserve's key operating unit, which daily buys or sells huge amounts of government securities and international currencies, he is the Fed official most closely in touch with Wall Street. He was to become the agency's point man in dealing with the developing crisis.

After learning of the credit squeeze facing Wall Street, Messrs. Greenspan and Corrigan feared that something far worse than a stock-market panic might be in the offing. If credit dried up, securities firms could start to collapse, much as the banks did after the 1929 crash. Fed officials saw a real threat of gridlock developing in the markets: Even the simplest financial transaction might have become impossible.

To avert that risk, Mr. Greenspan agreed to suspend, at least temporarily, the tightening grip the Fed had imposed on credit in order to head off inflation fears that he had seen building up in the economy. Signaling clearly its determination to prevent a market disaster, the Fed issued its extraordinary statement affirming its "readiness to serve as a source of liquidity to support the economic and financial system."

Even that was an understatement. Acting as the ultimate supplier of funds, the Fed flooded the banking system with dollars by buying government securities and thus quickly driving down short-term interest rates. "The Fed opened the floodgates of liquidity," says David Jones, the chief economist of Aubrey G. Lanston & Co., a major government-securities dealer.

Alerted by calls about the developing credit crisis from Mr. Phelan and others, the Fed leaned heavily on the big New York banks to meet Wall Street's soaring demand for credit. Mr. Corrigan and key aides personally telephoned top bankers to get the message across.

"Right from the beginning, Corrigan understood there was a major problem in the system," says Mr. Phelan, who spoke repeatedly to the New York Fed chief. Mr. Phelan sums up the Fed's strategy as he saw it: "The banks would be kept liquid; the banks would make sure everyone else in the system would stay liquid."

The banks were told to keep an eye on the big picture—the global financial system on which all their business ultimately depends. A senior New York banker says the Fed's message was, "We're here. Whatever you need, we'll give you."

Tuesday, 9:30 a.m. The New York Stock Exchange opened. But many important sectors were at a standstill. Two-thirds of the specialists' total $3 billion of buying power had been wiped out on Monday. Some specialists refused to open trading in stocks until they had enough buy orders to enable the shares to trade at higher prices. Many stocks took more than an hour to open. When they did, they were mostly up from Monday's close. The Dow opened about 200 points higher, an extraordinary gain.

But the euphoria was short-lived. Specialists and major firms quickly unloaded some of their huge inventories, and buyers evaporated. Stock-index futures began to plunge on several exchanges. Program traders and portfolio insurers, whose computer-generated trading had accelerated Monday's fall, were largely absent from the market. Program traders switch money between stock-index futures and the underlying stocks, depending on which is cheaper. Portfolio insurance is a method of hedging a stock portfolio, usually by selling futures contracts on stock indexes when the market falls.

Ordinarily, the huge discount of the futures contracts to the cash value of the underlying stocks would encourage selling of the stocks and buying of the futures. That, in turn, theoretically could trigger some buying of stocks at bargain prices. But as the morning continued, everything was being sold—stocks and futures alike.

Tuesday, 11:25 a.m. Of all securities linked to stock-market indexes, the Major Market Index has been the most secure, even in turbulent markets. It is pure blue chip: 17 of the 20 stocks in the index also are in the Dow Jones Industrial Average. Indeed, the MMI was created to mirror that average.

On Monday night, after the market turmoil that day, Ronald Shear, the American Stock Exchange's likable, balding senior specialist for the MMI, couldn't sleep. At 4 a.m., he gave up trying, and he went to the Brasserie, a 24-hour French restaurant in midtown Manhattan. Later, as the markets opened, he could hardly believe what he saw. One after another, major stocks broke down and couldn't be traded. By 11:30 a.m., when IBM stopped trading, the pace of closings was so fast Mr. Shear had trouble keeping track.

Big Board printouts of the morning's trading paint a harrowing picture of a market in disarray. By 11:25, even Du Pont hadn't opened. Merck opened at 9:46, was overwhelmed by sell orders and closed eight minutes later. Sears closed at 11:12; Eastman Kodak at 11:28; Philip Morris at 11:30; 3M a minute later. Dow Chemical shut at 11:43; USX at 12:51. Many other major stocks also weren't trading. Those that were did so only sporadically, in small numbers of shares or on regional exchanges. Over-the-counter market makers stopped answering their phones.

Specialists didn't have any buy orders, and many simply stopped making markets. Many believed that their capital, much of it in stock that looked as though it couldn't be sold, was gone or nearly gone. The specialists had run out of buying power. "The specialist system just let [stocks] go. People just stood aside," says Leslie Quick Jr., the chairman of Quick & Reilly Group Inc., a big discount brokerage firm.

Suddenly, Mr. Shear heard rumors coursing across the Amex floor. One turned out to be true: Tompane, the USX specialist on the Big Board, was about to be taken over by Merrill Lynch. Another later proved to be false: SEC Chairman David Ruder was about to announce the closing of the exchanges.

Sensing a similar imbalance in the options trading, Mr. Shear called a floor supervisor to check the rules for index-options trading on the Amex. The supervisor confirmed that if stocks representing more than 20% of the underlying capitalization of the index aren't trading, then options trading should stop. From what Mr. Shear saw, well over half the stocks in the index had stopped trading.

Mr. Shear got on the loudspeaker and halted trading in the MMI options.

Tuesday, 12:15 p.m. Leo Melamed, the short, dark-haired, kinetic chairman of the Chicago Mercantile Exchange, was on the phone to Mr. Phelan in New York. The Merc trades the Standard & Poor's 500, the principal futures contract used by program traders and portfolio insurers. Mr. Melamed was alarmed by the unprecedented breakdown in trading of the stocks making up the S&P 500. The Chicago Board Options Exchange, which trades options, had already closed because so many stocks weren't trading. "I was told there were no buyers," Mr. Melamed says. Then, he received a jolt: Mr. Phelan told him that Big Board directors were convening to decide whether to close the stock exchange. Mr. Phelan told him that "a decision was close," Mr. Melamed recalls.

Mr. Melamed suddenly envisioned a selling onslaught of the futures that could exhaust every bit of liquidity on the Merc floor. "We were exposed in a very dangerous way. We couldn't bear the brunt of any panic," he says. At 12:15 p.m., the Merc ordered a halt in trading of S&P 500 futures contracts.

A few blocks away at the Chicago Board of Trade, Chairman Karsten Mahlmann, known by his nickname, "Cash," also was on the phone to the Big Board. His exchange was still trading futures contracts on the MMI. But the situation was worsening: The MMI futures, already trading at the deepest discount to the underlying cash value of the index in its history, plunged further on the news that Mr. Shear had halted options trading on the Amex.

Mr. Mahlmann also was told that the Big Board was thinking of closing. But the Board of Trade was a little better off than the Merc. Trading of the relatively little-used MMI futures contracts had almost ground to a nervous standstill; MMI traders didn't seem to face a flood of orders.

Moreover, Mr. Mahlmann calculated that 17 of the MMI's 20 stocks still were trading, albeit sporadically, on some regional stock exchanges. Just the day before, Mr. Mahlmann had received a phone call from Beryl Sprinkel; the chairman of the President's Council of Economic Advisers urged him to keep the Board of Trade open. And there was the fierce long-standing rivalry between the Board of Trade and the New York exchange, a rivalry that has given rise to a generally defiant attitude at the Board of Trade toward any action adopted by the Big Board.

"We felt we had to stay open to do our job, to provide liquidity," Mr. Mahlmann recalls. Then he and his executives made what turned out to be one of the most critical decisions of the day: They kept the Board of Trade open and continued to trade the MMI futures contract.

Tuesday, 12:30 p.m. Mr. Phelan, Big Board President Robert Birnbaum, other top exchange officials and floor directors representing shellshocked specialists had gathered in Mr. Phelan's office to consider an extraordinary step: closing the New York Stock Exchange. The mood was grim. Mr. Phelan recalls that during the morning the market "was off 100 points and looked like it had potential to drop another 200 or 300. It looked like it would go again; it would be faster and heavier than the day before because there would be panic in the system." Exchange officials feared that selling would cascade as investors were hit with margin calls and big mutual funds dumped stock in the face of huge shareholder redemptions.

Behind the scenes, other pressures on Mr. Phelan to close the Big Board were multiplying. Several big securities firms "called the SEC and asked them to tell us to close," says Mr. Phelan (only the U.S. president and a stock exchange—but not the SEC—can order a closing). Mr. Phelan won't name the firms, but market sources say Salomon Brothers Inc. and Goldman, Sachs & Co., major firms with huge inventories of securities that were being rapidly devalued, were among those pushing to shut the exchange.

A Goldman official says the firm did discuss the possibility of a temporary closing with SEC Chairman Ruder but didn't recommend it. A Salomon spokesman didn't return a phone call.

"There were pressures from all firms that day to cut hours—to close," Mr. Phelan says. Donald Stone, a Big Board director, says there was also a discussion of a plan—broached on Black Monday—for big Wall Street firms to raise a $1 billion fund to keep specialist firms from going broke.

Mr. Phelan denies suggestions by Mr. Melamed and Mr. Mahlmann that he or other officials gave any indication the Big Board was on the brink of closing. He says he had talked during the morning to White House Chief of Staff Howard Baker. "They said if you can do it [stay open], do it," he relates.

Mr. Phelan says he shared White House fears over the impact of a Big Board closing. Shutting the biggest U.S. securities exchange not only would loudly trumpet the gravity of the stock-market crisis, "but the strain on the country . . . would be taken as an extremely bad sign," he adds. And reopening hundreds of stocks at once could later prove impossible. "If we close it, we would never open it," Mr. Phelan says bluntly.

Despite the intensifying pressures to close, the market was still officially open at 12:30.

Tuesday, 12:38 p.m. With the closing of the Big Board seemingly imminent and the market in disarray, with virtually all options and futures trading halted, something happened that some later described as a miracle: In the space of about five or six minutes, the Major Market Index futures contract, the only viable surrogate for the Dow Jones Industrial Average and the only major index still trading, staged the most powerful rally in its history. The MMI rose on the Chicago Board of Trade from a discount of nearly 60 points to a premium of about 12 points. Because each point represents about five in the industrial average, the rally was the equivalent of a lightning-like 360-point rise in the Dow. Some believe that this extraordinary move set the stage for the salvation of the world's markets.

How it happened is a matter of much conjecture on Wall Street. Some attribute it to a mysterious burst of bullish sentiment that suddenly swept the markets. Some knowledgeable traders have a different interpretation: They think that the MMI futures contract was deliberately manipulated by a few major firms as part of a desperate attempt to boost the Dow and save the markets.

According to this theory, the rally in the MMI futures contract was caused by a relatively small amount of concerted buying by one or more major firms at a time when it was so thinly traded that the orders had an enormous and disproportionate upward thrust. By forcing the futures contract to a premium to the underlying cash value of the index, the buyers of the futures could trigger immediate buying of the stocks in the index and selling of the futures by index arbitragers. Because so many of the MMI stocks are in the Dow, this would enable the NYSE to reopen many of these stocks at higher prices, leading to an upturn in this psychologically important index. At the very least, the buyers could flash a powerful bullish signal to the markets.

Mr. Mahlmann says he doesn't know whether this is what happened, but he says it is possible. "The market was extremely thin at that point," he recalls.

Statistics supplied by the Board of Trade lend circumstantial support to the thesis that the index was driven upward by a small number of sophisticated buyers. During the half hour—12:30 to 1 p.m. in the East, 11:30 to noon in Chicago—that encompassed the extraordinary rally, only 808 contracts traded, representing an underlying cash value of the index of about $80 million. The actual cost to someone buying those contracts can't be precisely determined, but it would have been a small fraction of the cash value.

Of the 808 contracts traded, about 70% were purchased at low commission rates. That indicates that the buying came from major Wall Street firms with their own traders on the floor. Only 30% of the buying came from so-called locals—smaller, independent traders who trade for their own and customers' accounts. The Board of Trade's statistician says this is an abnormally low percentage of local buying. Which firms were doing the buying couldn't be determined. Major firms contacted, including Morgan Stanley & Co., Kidder Peabody & Co., PaineWebber Inc., Goldman Sachs and Salomon Brothers, all either denied that they were responsible for the buying or declined comment.

As news of the rally in MMI futures reached the New York Stock Exchange (major firms maintain open lines both to their traders in Chicago and to specialists in New York), the market got another important psychological boost: the announcement of stock buybacks by major corporations. This, too, appears to have been encouraged by major investment banks, many of which spent Tuesday morning frantically calling chief executives of major clients urging them to buy back their stock. First Boston, for example, called about 200 clients.

"It looks like there's almost a get-together on the part of corporate America to prop up the market," Stanley Abel, a consultant specializing in buybacks, observed that day. Among the companies announcing buy-backs were Shearson Lehman Brothers Holdings Inc., Merrill Lynch, Citicorp, Honeywell, ITT, Allegis, four regional Bell companies and USX.

The precise timing of those announcements and any accompanying purchases are difficult to pinpoint, but some occurred during the crucial hour between 12:30 and 1:30. The USX specialist, for example, says trading in USX was halted at 12:43 p.m. because of a sudden influx of buy orders following the company's buyback announcement.

Floor traders at the Chicago Board of Trade say the major securities firms that maintain direct contact with specialists in New York were the first to learn of such buy orders, which in turn led to further buying by those firms of the MMI futures whenever the contract traded at a discount to the underlying cash index. (Indeed, the locals in Chicago have long complained that because the MMI consists of only 20 stocks, it can be manipulated by the major firms with access to Big Board specialists.)

A graph of Tuesday's movement in the MMI futures contract is consistent with such observations. At 12:45, the MMI contract had moved to a sharp premium to the underlying cash value of the index (so many of the stocks weren't trading that the underlying cash value was calculated using recent trades that probably overstated its true value at the time). The graph shows that the contract immediately turned downward, as traders presumably sold the futures and began to buy the underlying stocks, thereby locking in a profit.

One index arbitrager admits using such a strategy. "I did it very, very cautiously," he says. "I was terrified of the market. But it was a very profitable move."

If the goal of those buying the MMI futures beginning at 12:38 was to drive up the Dow, it succeeded brilliantly.

Tuesday, 1 p.m. Like water on parched earth, buy orders began flowing into securities firms and into the stock exchange.

Banks, including the recalcitrant Bankers Trust, had finally pledged their support after receiving reassurances from the Fed, giving specialists and other firms the financial confidence to execute orders. The Fed told the banks that they were free to increase their borrowings at the Fed's discount window. New York's Chemical Bank increased its loans to securities firms for that week by $400 million above normal, a bank official says.

All told, the 10 biggest New York banks nearly doubled their lending to securities firms that week to $12 billion, pumping in an extra $5.5 billion.

A spokesperson for Bankers Trust says, "We were able to accommodate routinely the financing requirements of our major customers in an environment characterized by great uncertainty. The requirements of most others were met after greater than usual consideration."

As the buy orders reappeared, large capitalization stocks—especially those in the MMI—began coming back to life. Merck reopened at 1:15, albeit 21 points lower, and IBM reopened at 1:26 at 112, unchanged from two hours earlier. By 2 p.m., when USX reopened, up 62½ cents, all the MMI stocks were trading.

Mr. Phelan told his counterparts at the other exchanges in New York and Chicago that the day's threat of closing had passed, that the immediate crisis was over. At the Amex, Mr. Shear got on the loudspeaker to announce that MMI options would resume trading in 15 minutes. Mr. Melamed ordered the resumption of futures trading on the Merc, and the Board of Trade's Mr. Mahlmann breathed a great sigh of relief. "We were immensely pleased that the market came back and that we were the ones who stayed open," he says.

Tuesday, 4 p.m. The stock market ended its tumultuous day with a record—and psychologically crucial—gain of 102.27 points in the Dow. Volume was also a record 608,120,000 shares, a little higher than on Black Monday. On the Big Board overall, 1,398 stocks declined. Only 537 gained.

The Dow's rise partly reflected the strong peformance of the stocks that make up the MMI. Throughout the afternoon, the MMI futures traded several times at a premium to the cash index, apparently triggering buying of the underlying stocks. The performance of the MMI futures diverged significantly from that of the S&P 500, which remained at a deep discount to the index even after it reopened.

Because of the Fed's aggressive move to drive down interest rates by flooding the system with liquidity, the bond market, too, rallied strongly, providing crucial support for the broader financial system. "If the bond market had been going the same direction as the stock market—down—that would have been the straw that broke the camel's back," Mr. Phelan says.

* * *

On Wednesday, Americans woke to newspaper headlines proclaiming the largest rise in the Dow's history. A wave of optimism washed over the exchanges. The stock market that day was to have a real rally—186.84 points on the Dow, with 1,740 stocks gaining. ▬

In the end, the stock market and financial system didn't collapse on Tuesday. Although trading losses—mainly in takeover-related stocks—ran into hundreds of millions of dollars, no major securities firm defaulted on its obligations to customers or was rendered insolvent. A few specialist firms merged or were forced to find new infusions of capital; most survived. But privately, key participants say they were deeply shaken by how close to catastrophe the system came.

And the crisis in the financial system revealed glaring weaknesses that are being closely examined in Congress. The New York Stock Exchange specialist system—despite some heroic efforts—proved inadequate to meet the demands of huge international flows of capital, nearly triggering a shutdown of the exchange and a public crisis of confidence. Though there is little to suggest that program trading or portfolio insurance caused the crisis, both contributed to a degree of volatility that the system couldn't handle.

"The markets will be nothing but an open casino if you let this continue," Mr. Phelan says.

More worrisome, many officials note, is that the crisis occurred in the absence of any true calamity. What might happen to the markets in a major political or economic crisis? Could a real meltdown happen?

"I won't even get into that," the Me[illegible] Mr. Melamed says.

Glossary of Terms

INDEX ARBITRAGE—The simultaneous trading in stock-index markets and the underlying groups of stocks to take advantage of temporary discrepancies in prices.

MARGIN CALL: A demand upon an investor to put up more collateral for securities bought on credit. The lender, usually a bank or brokerage firm, makes the call when the equity in the investor's account falls below a standard set by a stock exchange or firm.

OPTIONS: A "put" option permits a holder to sell a stock at a specified price within a limited period. A "call" option permits an investor to buy stock at a specified price within a limited period. An index option lets the investor buy or sell the "basket" of stocks represented by a stock-market index.

PORTFOLIO INSURANCE: A method of hedging a stock portfolio, usually by selling futures contracts on stock indexes when the market falls.

STOCK-INDEX FUTURES: Contracts for future delivery of an amount of cash based on an index of stock prices, such as the Standard & Poor's 500 index or the Major Market Index. A trader buying a December S&P 500 stock-index futures contract at a price of $200 today, for instance, would be agreeing to take delivery next month of 500 times that amount in cash, or $100,000. Traders would almost always close out that position by selling an offsetting futures contract.

If the stock market—and correspondingly the stock index—rose before the trader closed out his position, he would make a profit because he could sell an offsetting contract at a higher price, taking in more money than he had to spend. If the market fell, the trader would lose money because he would have to sell an offsetting contract at a lower price. Futures are used to hedge against fluctuations in stock prices or to speculate on market moves.

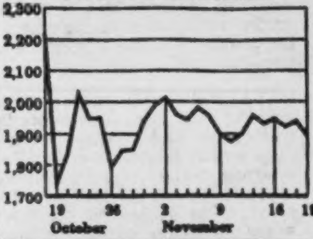
(The Major Market Index encompasses 20 blue-chip stocks, including 17 that are also in the Dow Jones Industrial Average. Futures on the MMI are traded on the Chicago Board of Trade. Options on the index are traded on the American Stock Exchange.)

The Difference One Month Makes

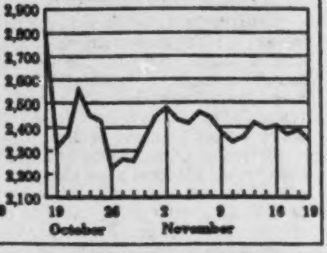
U.S. Stocks

Since the morning of Black Monday the DJIA has lost close to 14% of its value; the Wilshire Equity Index, the broadest measure of U.S. stocks, is off 12.5%.

Dow Jones Industrials



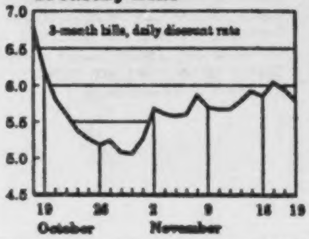
Wilshire 5000



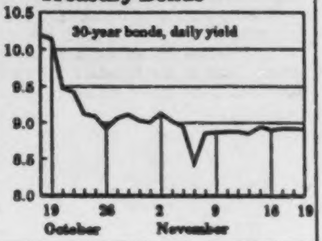
U.S. Interest Rates

The Federal Reserve Board pushed interest rates lower. Three-month Treasury bill rates have fallen to 6%; Treasury bonds that were yielding 10.25% are now at 9%.

Treasury Bills



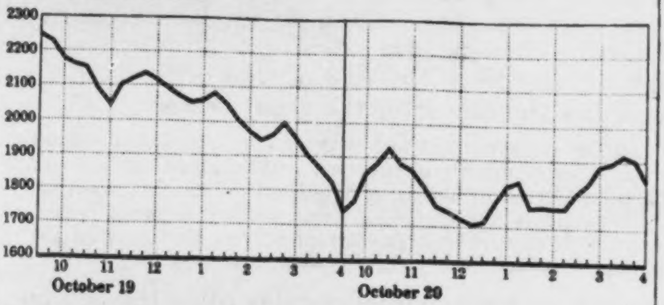
Treasury Bonds



After the Crash, the Real Crisis Begins

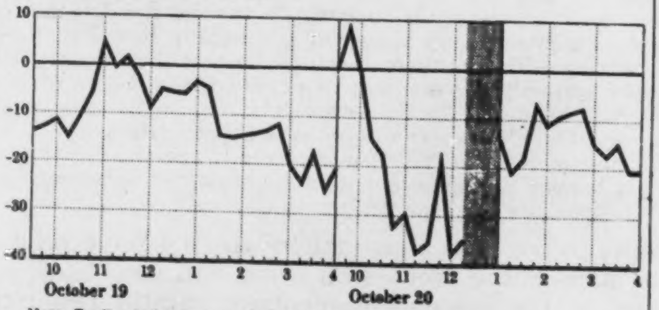
The Dow Jones Industrials

At 15 minute intervals



S&P 500 Cash-to-Futures Spread

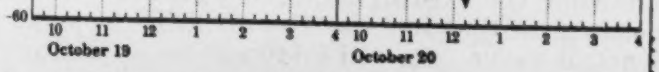
In points, at 15 minute intervals



NOTE: Trading in futures contracts halted between 12:15 and 1:05

Major Market Index Cash-to-Futures Spread

In points, at 15 minute intervals



Anatomy of Tuesday's Turmoil

Even though some stocks rebounded in early trading Tuesday—the Dow was up 200 points at 10:30—sell orders quickly swamped the exchange and many stocks stopped trading. By 12:15 the Dow was down 30 points (top chart). Trading in futures contracts on the S&P 500, the basis for most program trading and portfolio insurance, ceased because so many of the underlying stocks had been halted with the futures trading at a record discount from the index's cash value (middle chart).

Only the relatively thinly traded futures contract on the Major Market Index, a Chicago Board of Trade contract based on a basket of 20 blue-chip stocks, continued to trade (bottom chart). The sharp rebound at 12:45—which could have been sparked by relatively little buying—evidently was able to rally the stock market, which in turn allowed more stocks to open.

Source: Knight-Ridder Tradecenter

Senator **Wirth**. Let me, if I might—I want to get to the point of looking at the proposal that we have made for a Financial Services Oversight Commission, if I might, Mr. Greenspan, but I'd like to frame that and read from this article and then point out why I think what we are proposing is absolutely crucial and what you are supporting and the steps taken so far by Senators Proxmire and Garn doesn't go far enough.

I'd like to read from the end of this article. This is a discussion you remember the day after the great crash.

> In the end the stock market and financial system didn't collapse on Tuesday. Although trading losses mainly in takeover related stock ran into hundreds of millions of dollars, no major securities firm defaulted on its obligation to customers or was rendered insolvent. A few specialist firms merged or were forced to find new infusions of capital. Most survived. But privately, key participants say they were deeply shaken by how close to catastrophe the system came.

Now this is in discussion of the day after the 500 point drop.

> The crisis in the financial system revealed glaring weaknesses that are being closely examined in Congress. The New York Stock Exchange specialist system, despite some heroic efforts, proved inadequate to meet the demands of huge international flows of capital, nearly triggering a shutdown in the exchange and a public crisis of confidence. Though there is little to suggest that program trading or portfolio insurance caused the crisis, both contributed to a degree of volatility that the system couldn't handle—"The markets will be nothing but an open casino if you let this continue," Mr. Phelan out of New York Stock Exchange says. More worrisome, many officials note, is that the crisis occurred in the absence of any true calamity. What might happen to the markets in a major political or economic crisis? Could a meltdown happen? I won't even get into that.

It seems to me that that article which I have read a number of times in some detail focuses on some real structural problems that we've got in the system—inadequate capital resources available, the fact that many times the specialists just couldn't do the job that they're supposed to do on the floor, the close tie-in of the exchanges with the MERCK.

FINANCIAL SERVICES OVERSIGHT COMMISSION

Now the Financial Services Oversight Commission that Senator Graham and I have suggested in our legislation attempts to take the view beyond the powers view that you supported and has been taken by Senators Garn and Proxmire.

What we are suggesting is that we have to do a much better job of rationalizing the existing regulatory structure. We have to have some mechanism that looks at the MERCK, looks at CBOE, looks at the various exchanges, and relates those as well to our financial institutions—the banking institutions. And we provide a framework as well for those institutions that aren't regulated. I mean, you know as well as I do there are large parts of American Express that go unregulated, large parts of General Electric that go unregulated, and we don't have any mechanism to look at those. They are just as much a part of the financial structure as the institutions that are regulated. Why are some regulated and why aren't others?

Third, we attempt to provide a mechanism that will allow us to look at the future, particularly at the international markets. It seems to us that if we don't end up rationalizing what's going on domestically in the United States, there is no way in the world we can hope for some greater rationalization of the world marketplace and we have no mechanism for doing that.

The question, having stated all of that and the purpose of that kind of an oversight commission built into the legislation, is to ask for your reaction to that as an idea and mechanism that ought to be set up.

Mr. GREENSPAN. Well, Senator, let me say first that there are going to be a number of studies of the October 19th, 20th and thereafter period. The current one, the Brady task force, will be looking into a number of issues with respect to the presumed causes of the market decline and one of the things I would caution is that whenever you have a phenomena of this sort, it is always an extraordinarily more complex set of interrelationships than seem to appear on the immediate surface.

As a consequence of that, I must say I would be hesitant to recommend that this committee or the Congress move forward in making assumptions about what actually occurred in these various different periods——

Senator WIRTH. Sir, we're not doing that. Let me just interrupt. This doesn't do that.

Mr. GREENSPAN. I just wanted to merely address the immediate concern.

Senator WIRTH. I understand the immediate concern and I understand the need for caution and we have certainly not said that we ought to jump in with *x, y, or z* specific structural change.

What this legislation says, Mr. Greenspan—and I think that the administration has for the last 6 years missed this point and I think that this is being missed as well if we just focus on powers legislation—is the fact that we have got to figure out how to rationalize and coordinate what goes on in New York, the New York Stock Exchange, what goes on in Chicago at the MERCK, what goes on with the relationship of that to CBOE, how that relates to the Comptroller of the Currency and various bank powers, and how, in turn, what we're doing in this country begins to relate internationally. If we don't do this, we're just nibbling away and continue to do so at the edge with some kind of a feeling that regulation or deregulation is the goal, which it's not; that we ought to be looking at the system overall.

There is no mechanism that I have seen in the Proxmire-Garn legislation that even attempts to address that. What we are attempting to do is to address that overall and at least set up a process for starting to look at that, which is the thrust of the oversight commission.

The question is, is that a good idea or not?

Mr. GREENSPAN. I was about to say—I'm sorry I didn't get to it earlier in my long answer, Senator—that it is a good idea. I think we sense the need for increased coordination amongst the various regulatory authorities. It occurs on an ad hoc basis, largely because clearly we all speak to each other constantly, and in effect, de facto, are creating coordination. But I certainly agree with you that the thrust of what you're saying is something with which we subscribe.

Senator WIRTH. I know my time has long ago expired, Mr. Chairman, but I would just point out finally that this kind of ad hoc coordination is not adequate to do the job. Nobody has the power to force compliance with any kind of a broad approach that might be agreed upon. Nobody has that kind of authority and power now. So consequently, we continue to have a number of conflicting and often squabbling jurisdictions which doesn't make any sense at all. We have conflicting capital requirements from one kind of operation to another which makes no sense at all. It seems to me that the argument is very strong for us looking very carefully at such a commission and such a coordinating mechanism and it seems to me, again as we were talking last week, Mr. Chairman, figuring out how this might be built into the thrust of what you and Senator Garn are doing is something that we ought to look at very carefully and probably do.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I'd like to continue to pursue the line of questions that Senator Wirth has been advancing.

Mr. Chairman, you stated that the Glass-Steagall provision is the single most important anomaly in our financial structure. What would you list as other anomalies that would justify congressional attention?

Mr. GREENSPAN. Well, I can list them as a private citizen and did. Let me just say as a private citizen that I think the McFadden Act and the Douglas amendment which restrict interstate banking struck me as a private citizen—and I must admit it doesn't strike me terribly different at the moment—as not very helpful.

If you would like, I will list a series of other lesser structural problems which might be useful in answer to your question.

Senator GRAHAM. I would like to see that and then I would ask that you supplement your list with this process question.

In your statement on page 34 you state:

> It seems to us that there are major advantages to proceeding on an incremental basis starting with securities powers where the rationale for change has been clearly established. In this way, we can have the benefits of change while gaining experience with the systems that are necessary to assure this change is carried out in a responsible and effective manner.

I would be interested in your assessment of once we've identified the other anomalies what sequence and process you would recommend the Congress undertake in order to deal with the resolution of those questions.

Mr. GREENSPAN. It's a very difficult question to answer, Senator, but I will try to answer it for the record.

Senator GRAHAM. The thrust of both of those questions is that I think that your list of anomalies is going to be a lengthy one.

Mr. GREENSPAN. I'm aware of that.

Senator GRAHAM. And that it is difficult to arrive at a rational basis for sequencing of which parts of the anatomy we will treat first. That returns me to the position that is fundamental to the legislation Senator Wirth and I have introduced, that we need to look at the total system as a system and establish a process by which we can begin total reconstructive surgery as opposed to focusing on one aspect of the problem.

I am concerned that you seem to feel that we should take a finger-by-finger approach.

Mr. **Greenspan**. Senator, I must admit to you that it is not an easy decision to come to and I will also acknowledge that a goodly part is based not on what an economist thinks is the right thing to do in principle but what is feasible and practical to do in a legislative environment.

There's really one major reason why one does not want to go all the way discontinuously in a very major area of the economy. The reason basically is that as certain as one may be about what the outcome of a certain structure could be, you are never certain. And if you're wrong, if there are unforeseen technical problems in the structure, the cost to the economy could be large.

It's not elegant to go incrementally or, as you say, finger-by-finger, but it does have the advantage of delimiting the downside in that process. And we have concluded, as a Board, that considering all of the complexities that are involved, the repeal of Glass-Steagall strikes us as a major important change which in and of itself will significantly improve the banking and financial structure of this country.

I would not wish to rule out in making that statement, Senator, that at some point further changes would not be appropriate or consistent with Glass-Steagall alterations.

Senator **Graham**. Mr. Chairman, my time has expired. I'd just like to conclude with an observation that in this business of economics and politics, you have to decide how to expend the momentum for change which is available, whether to do it for small victory or for a larger objective.

I believe that prior to October 19 there was substantial momentum for change, as witnessed by the fact that the Congress passed legislation earlier this year well in advance of the crisis atmosphere of the last 6 weeks and did so with commitments to itself and to the American people that this was an interim step.

I do not believe that we ought to squander this opportunity for major change lightly on an important but I think relatively isolated aspect of the total problem and that in assessing the downside risks, that I think the downside risks of continuing with the incoherent regulatory pattern, a process that will as assuredly as we have done in our industrial sector see our financial institutions become dominated by foreign interests, we will continue to see major unregulated aspects of our financial institutions become more competitive with the regulated sector, therefore placing the regulated sector under greater stress in terms of its vulnerability—that those downsides risks are substantial, immediate, tangible, and that those need to be given serious weight in terms of whether we should take a total or incremental approach to dealing with this problem.

The **Chairman**. Senator Sanford.

Senator **Sanford**. Thank you very much, Mr. Chairman. I had to preside so I couldn't be here for an opening statement, but I would appreciate your putting it in the record.

The **Chairman**. Without objection, it will be printed in full.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Mr. Chairman, I commend you for holding the series of hearings you have planned for this morning, the remainder of this week and next week. I would also like to join my colleagues in welcoming Chairman Greenspan this morning and in congratulating him on his decisiveness and calm during the recent downturn in the stock market. I know we all appreciate Mr. Greenspan's quick decision to inject liquidity into our financial system. I also appreciate the thoughtful and comprehensive testimony he has provided us this morning.

Mr. Chairman, I would also like to commend you and our ranking minority member, Mr. Garn, for working together to present the committee with an excellent bill that takes this important step of permitting banks broader securities powers while also establishing crucial safeguards for the safety and soundness of our banks. In addition, I want to thank Senator Graham and Senator Wirth for their efforts in distilling the Corrigan plan into a legislative proposal. I believe the Graham-Wirth bill focuses attention on a number of critical issues, including access to the payments system and the need for greater coordination of our financial services regulators. I understand that our colleagues Mr. Cranston and Mr. D'Amato will also be introducing more comprehensive legislation embodying the proposal put forward by the Financial Services Council.

I look forward to today's hearing and the additional hearings that will follow on comprehensive financial restructuring. As I stated during our debates on S. 790, I am committed to examining the many questions that a reform of our financial services industry raises and to pushing for legislation that will place our financial services industry on a more competitive footing.

I believe that the time has come to reform many of the laws governing our financial system. If we are to maintain an open, competitive capital market and to allow our banks the opportunity to compete on a fair basis with the tremendous domestic and foreign competition they now face, we must establish a procompetitive environment. We can no longer permit markets developments, foreign actions, new technologies, and regulatory reforms to govern the future structure of our financial system.

I believe that we need to begin this process with some very fundamental questions—what do we want our financial system to look like when we finish the process? What long-term objectives should we keep in mind in mapping out a structure for our financial services? How do we protect our Federal deposit insurance system while allowing greater competition? Is there really a line between finance and commerce, and if so, should it be retained? I believe the legislative proposals that have been introduced and the testimony presented by Mr. Greenspan go a long way toward providing some of the answers to those questions and look forward to exploring the answers to these and other questions in more detail.

In light of the stock market crash, the economy is now viewed in terms of before and after, with October 19 being the point of demarcation. Yet, as we hopefully regain our equilibrium from the gyrations of the stock market, we should not foresake our long-term goals and policy objectives. Modernization of our financial system remains as necessary now—if not more so—as it was before October 19 and we should not be timid in implementing long overdue reforms.

Mr. Chairman, I commend your efforts in calling for these hearings and in presenting the committee with an excellent bill to use as a focus on our debate.

Thank you, Mr. Chairman.

While I've got the Chairman here, I do in my statement and I would like to commend him for his decisiveness in the recent downturn in the stock market as well as his cool hand. I thought that was a great influence.

Mr. GREENSPAN. Thank you, Senator.

Senator SANFORD. Mr. Chairman, I thank you for bringing together this piece of legislation. I certainly commend you for it. I think it's a splendid piece of legislation and I especially commend you for involving Mr. Garn and giving it a bipartisan approach that I believe will be very beneficial.

To my two colleagues here, I certainly thank them for getting the Corrigan plan into a workable piece of legislation and I think together now we've got some very good opportunities to have strong legislation.

Mr. Greenspan, if I may ask you just for an elaboration of what we've been talking about—and I don't think we have had your statement on it—if so, we will all pass—but on page 33, you urge us to give further thoughts to how the proposal contained in the Wirth-Graham bill for a broadly representative financial regulatory body could be incorporated into the structure set forth in the Proxmire bill.

Could you give us some at least preliminary thoughts on how you see the broader regulatory body meshing with the approach of the Proxmire-Garn bill?

Mr. GREENSPAN. Well, it gets in part to the issue of coordination which Senator Wirth was referring to. There are a number of elements in the bill which are really quite parallel to the Proxmire-Garn bill and are not contradictory. There are certain elements which are quite different and you have to choose one or the other, but there are many elements which overlap and I think a number of the principles enunciated in the bill are worth serious thought.

In general, I don't want to argue that one bill is exceptional and the other bill is poor. That's not the case. These are in many respects bills which focus on complementary areas. It's merely a question of how far the committee would like to move in that direction.

STATE REGULATED NONMEMBER BANKS

Senator SANFORD. You have commented on a number of collateral matters, but one that maybe is worth a little more elaboration, do you have any thoughts that you would like to express now on what we ought to do about the State regulated nonmember banks, as well as the so-called nonbank banks that aren't specially gathered up into these two pieces of legislation?

Mr. GREENSPAN. Well, actually the State nonmember banks are covered with respect to securities powers. The nonbank banks are not technically involved. That's an issue which the Congress should address, if it hasn't already addressed it finally in CEBA.

Senator SANFORD. Have you expressed any policy position on nonbank banks?

Mr. GREENSPAN. The Board has not, on this issue in this legislation.

Senator SANFORD. Looking at your testimony, the thing that intrigued me, you note that the five largest underwriters of commercial paper account for over 90 percent of the market and the five largest of all domestic corporate debt accounts for almost 70 percent of the market. Now we are talking about letting banks come in to provide greater competition, but there don't seem to be any major barriers to entry of other securities firms into this kind of business. Why the monopoly or why the concentration?

Mr. GREENSPAN. Well, I wouldn't say it's a monopoly, Senator. I would say it is concentration. But let me emphasize, as I've said in other forums, that I'm not arguing that the securities industry is monopolistic nor am I saying that there is no competition there. On the contrary, I think there is a considerable amount of competition.

What I am saying, however, is that considerably more competition is capable of being brought to bear and the types of institutions, in this particular instance the larger commercial banks, have the capability of being formidable competitors and I think in that sense bring customer costs down.

Senator SANFORD. Thank you very much. My time has expired. I thank you.

The CHAIRMAN. Mr. Chairman, later this week Chairman Ruder of the SEC will say that the SEC cannot support S. 1886 unless it's amended to allow the SEC to regulate all ongoing securities activities of banks, including brokerage services and selling mutual funds.

Would you support those changes toward functional regulation recommended by the SEC?

Mr. GREENSPAN. Well, as I indicated earlier, I think that in general principle we do. I'm not certain about the specific details in all respects, but I would certainly say we have no major divisions with the SEC Chairman that we are aware of.

The CHAIRMAN. This would be extending SEC authority to areas where they don't exercise it at the present time, as I understand it.

Mr. GREENSPAN. I have met with Chairman Ruder and I cannot say to you that I found that his particular concerns or point of view were significantly different from ours. I merely hesitate to be terribly specific about a very detailed functional procedure which I have not given as much thought as I think is required to have a conclusive opinion.

The CHAIRMAN. One argument for keeping banking and securities activities separate is the possibility of tie-in sales and the abuses of tie-in sales. That is, a bank might put pressure on its business customers to use the services of its securities affiliate. Even though the bank would not formally condition the availability of credit on buying its securities, the customer will nonetheless get the message and behave as though the tie-in sales were required.

Now what's your response to the possibility of involuntary tie-in sales in the banking and securities business?

Mr. GREENSPAN. Well, I'm sure that it's often difficult to know what a tie-in sale is because sometimes it's subliminal; sometimes it's what appears to be endeavors by one party and not perceived by another party. I think it's an inappropriate activity and what we should do as best we can is to try to find means to avoid that.

The CHAIRMAN. Do you think we can effectively do that?

Mr. GREENSPAN. Fully, no. I don't think so, nor do I think we do it now. I don't think that is the type of thing which you can fully legislate against, since sometimes it is awfully vague and nonspecific, but it is improper.

The CHAIRMAN. But you don't feel apparently—because you support the legislation—that the repeal of Glass-Steagall is going to significantly or substantially increase that?

Mr. GREENSPAN. I doubt that.

The CHAIRMAN. Now in your November 18 testimony before the House Banking Committee you said that the Federal Reserve Board favored a total repeal of Glass-Steagall prohibitions on securities activities rather than a piecemeal removal of restrictions on underwriting and dealing in specific types of securities such as revenue bonds or commercial paper.

You said that the piecemeal approach would artificially distort capital markets and prevent financial institutions from assuring benefits to customers by maximizing their competitive advantage in particular markets. Those were your words.

PIECEMEAL APPROACH

Can you explain why a more limited approach to granting banks securities powers would artificially distort capital markets and not maximize consumer benefits?

Mr. GREENSPAN. Senator, what happens if you merely specify an individual power to an individual institution is that you eliminate his ability to engage in the most efficient form of organization that he has. What occurs in the process is that you create artificial changes in supply, restricting certain institutions and not others or changing them, and it doesn't enable the total financial structure to seek to produce those types of benefits and those types of products which consumers most desire.

In a fully free market with no restrictions whatever, ultimately it will be consumers who will determine which financial products are profitable and which are not. And those which will be supplied will be those which are profitable.

When we superimpose a regulatory structure on a fully free market for purposes of safety and soundness, we should endeavor to impose one which minimizes the restrictions that occur to the free flow of capital. Piecemeal approaches tend to be restrictive in that respect.

The CHAIRMAN. Thank you. My time is up. Senator Riegle.

Senator RIEGLE. I have several things, Chairman Greenspan. If we go down this track that you're laying out here of combining investment banking and commercial banking, how do you view the next big question and that is, combining that new combination of banking and securities activity with commerce generally? Do you think that wall has to be maintained or can we now foresee a future in which we let anybody that basically wants to and has the desire and the capital strength to combine commercial activity broadly defined and banking and investment banking activity?

Mr. GREENSPAN. If we eliminate Glass-Steagall, I think that creates a major improvement in the overall financial structure, wholly independently of whether the next step is taken.

As you know, Senator, there are innumerable analysts who are in favor of one but not the second, and many who are in favor of both.

In principle, you can be in favor of the elimination of Glass-Steagall and against the issue of breaching the wall which now exists between commercial business and banking. Indeed, the Corrigan proposal, which Senators Graham and Wirth embody, in fact does precisely that, even though it is clearly a much more expansive financial system.

The Federal Reserve Board has chosen not to go that next step on recommendation. There are a number of members, myself included, who in the past and currently are favorably disposed in that direction. But it's our view as a Board that that is not something which we think is appropriate to recommend largely because it would create, from where we stand now, a very large change. And for the reasons I expressed in an earlier response, I think there are risks in moving which probably could be far better done incrementally if it's the desire of the Congress to move in that direction.

Senator RIEGLE. The reason that I pose that question—and I think we have to force ourselves into discussing it to a tighter answer—when Don Regan was Treasury Secretary and appeared here, he made it clear at that time that the vision of the Reagan administration was to pursue this all the way to the end. That was to get to one-stop shopping and a comingled system with commerce and banking combined.

I think it's very important if what the Fed is thinking and saying and what your own view would be that we're going to do this a step at a time and we sort of like the concept down the road of combining commerce and banking but we're not prepared to announce it now, I think that changes the form and the landscape of the debate. That seems to me to be a very fundamental question and I don't know that it can just sort of be finessed off and left as a second step with a question mark.

I think we have to see where we're going here before we really sort of make the first big step, at least in my mind.

Mr. GREENSPAN. I understand what you're saying, Senator, and I don't disagree with that.

Let me just say that I don't want to imply to you that the Board has a secret agenda. We do not. In fact, I am not even certain that there is a majority on the Board for that second step. We have discussed it almost peripherally in other discussions and never seriously approached the issue.

What we are committed to and are recommending is support of the Proxmire-Garn bill on the grounds that that is a wholly independent action. It's good in and of itself. Whether or not the Board at some later date either supports or opposes stage two is really, in my judgment, quite irrelevant to the considerations with respect to the individual piece of legislation. There is nothing that I am aware of which says that if you take step one, step two of the type you describe is in any way implied.

Senator **Riegle**. Well, I think what you're going to see happening—and I see it happening with a major industry in my State, the automobile industry, which has moved into financial-type activities—all of the major automobile companies have as is well known—and it seems to me that if we were to find ourselves with the proposal which you're advancing now being in the law, if that were the law, that the next thing that would happen is that commercial firms of all sorts would be in here saying that they want to be in this game as well. It seems to me if we don't anticipate that and if we haven't answered that question on the front end, and particularly from a Federal Reserve point of view because we're still talking safety and soundness, we're still talking Federal deposit insurance, we're still talking access to the Fed window and the creation of credit to run the system—I'm not comfortable with disconnecting these enormous questions of that sort from that fundamental question of what stands on top of Federal deposit insurance.

We haven't talked yet today about whether this proposal would apply to savings and loans. I assume it would.

Mr. **Greenspan**. I'm sorry. Which proposal?

Senator **Riegle**. Well, the proposal you're laying out. You don't propose that banks could get into the securities business but savings and loans could not, I assume.

Mr. **Greenspan**. Well, we are in a sense supporting the existing legislation.

Senator **Riegle**. No, but you envision that savings and loans, as apart from commercial banks, would be allowed to do the same thing——

Mr. **Greenspan**. Oh, yes.

Senator **Riegle**. To do exactly the same thing, create a securities affiliate, is that right?

Mr. **Greenspan**. Yes. Senator, let me just respond to your question because I think it's a terribly important one.

I think that the so-called second step does require the type of evaluation which you suggested—a very close look at the implications of the Federal safety net, including deposit insurance; the whole issue of the Fed wire; and how the whole structure of the discount window and access is applied.

We at the Board have not even remotely endeavored to address this issue, which is very large and one which cannot be taken lightly. I think it's an important question. I think one which ultimately is worthwhile exploring, but I'm not saying that the Federal Reserve is anywhere near even thinking in terms of this question largely because it is a very complex question and it's not on our agenda.

Senator RIEGLE. I'll conclude here just with this thought for you to think about for the next round, and that is this; that if your proposal becomes law, that proposition becomes the next day's issue, the next day's debate. And certainly I think we can all foresee that, that if we take the first step, you're going to have an immediate effort mounted by many people to move on to step two and to think there will be a nice, long measured hiatus between those two things I think is just not the way things would work.

Mr. GREENSPAN. I would say, Senator, that I think it would be a mistake in any event, even if the Congress ultimately at some time down the road decided to do step two, to do it right now.

The CHAIRMAN. Before I call on Senator Wirth, let me point out that Senator Cranston and Senator D'Amato are proposing that we take the second step and probably a third and fourth also in their big bite.

All of this has to come before the Congress, as Chairman Greenspan has pointed out. It's up to us to make that decision. There's no reason why we shouldn't consider the whole thing, but before us now, at least in this particular bill that we have been discussing mostly this morning, we take just this one step.

Senator Wirth.

Senator WIRTH. Thank you, Senator Proxmire. I must say that before us now are two pieces of legislation, the one that you and Senator Garn have introduced and the one that Senator Graham and I have introduced, which is significantly broader.

Let me again say, Mr. Greenspan, I'm getting the sense that sometimes you get it and sometimes you don't, and let me try again.

You said in response to Senator Graham's question and just recently in response to Senator Riegle's question—I can almost quote you—"one does not want to go all the way discontinuously in a major sector of the economy. If you're wrong, you run into major penalties or costs."

We are not proposing, Mr. Greenspan, that we are going to define exactly what happens in steps two, three, four and five. What we are saying is that it is essential to set up a mechanism or a regulatory structure that will allow our financial institutions to be coordinated. That's what the oversight commission is all about.

Now there's no discontinuity in there. There's no risk in doing that. The only risk that I can see we face is the risk that might come from all the various constituencies—I hope it's not the Federal Reserve—from the various other groups that are going to have maybe some of their jurisdiction taken away by a group that's going to have a broader oversight responsibility.

So, please, don't confuse the argument by saying that what we are doing is going all the way discontinuously. We are not. All right? Let's remove that from the argument and understand what it is the mechanism that Senator Graham and I are proposing we set up.

Mr. GREENSPAN. On the issue of coordination, I think it's a worthwhile and important endeavor which we support.

NATIONAL ELECTRONICS PAYMENTS CORPORATION

Senator **Wirth**. OK. Let me go on if I might then to focus on another element in our legislation which has not been touched upon at all this morning and is not touched on in the Garn-Proxmire legislation. That is, the focus on the payments system.

Senator Graham and I have proposed the establishment in title III of our legislation of a national electronics payments corporation. This is in response—I might read from the Corrigan report:

> As discussed earlier, the large dollar electronics payments mechanism plays a vital role in the day-to-day, hour-by-hour functioning of the financial system. The fact that these systems are able to process tens of thousands of transactions daily, aggregating well in excess of a trillion dollars is testimony to their effectiveness, but it also underscores the urgency of ensuring that these systems are as reliable as possible and are capable of dealing with operational credit or liquidity shocks.

What we have attempted to do is to develop a broader mechanism, a more up-to-date mechanism, to meet the argument that's been made by a whole variety of experts and studies arguing that our current payments system simply hasn't kept up with the private sector and that this is going to get worse as our domestic economy is more intertwined in the international economy.

I was wondering if you had any reaction to the proposal for setting up a national electronics payments corporation, if that is a good idea, if that ought to be part as we believe of this legislation?

Mr. **Greenspan**. Well, Senator, I certainly think it should be studied because I fully concur with Gerry Corrigan's notions about this. He has done an extraordinary job in evolving a system at the Federal Reserve Bank of New York where most of the operational facility resides.

In the process, I personally have spent a rather considerable amount of my time looking at that system and I must say to you it's awesome in content—just talking about the state of the art—and potentially of grave concern about how the system is going to function in the years ahead as inevitably the volume of transactions continues to multiply at an extraordinary rate.

I do think that this has to be worked on. The Federal Reserve is and has been in the process for quite a while in trying to think through and upgrade the process and I would certainly say the notions in your bill are something which require a good deal of study and I ultimately suspect that something in that direction will be required.

The problem that exists obviously rests with the interface—for example, the Fed wire on the one hand and the CHIPS system, the private clearinghouse system, on the other. What we have to be careful of is to what extent we use Federal and private resources in a national payments system.

It's in those areas where considerable thought has to be given, but I certainly fully subscribe to the general thrust of your argument that something in this direction will ultimately be required.

Senator **Wirth**. Perhaps we could get your specific responses to this as a legislative proposal. It seems to me, Mr. Chairman, one of the important things we ought to be doing is taking advantage of the opportunity that exists now, as Senator Graham pointed out, and this is an area Mr. Corrigan and the New York Fed deals with on a steady basis. They think, to use my words, it's being held together currently by bailing wire. It has a possibility of creating some very, very severe problems for the overall system in the future and this might be an ideal opportunity in this piece of legislation to focus on the payments system.

So maybe we could get from you your response to that and say, OK, let's do more than study it; let's figure out what we can do about it.

Mr. **Greenspan**. We will, Senator.

Senator **Wirth**. Thank you very much.

The **Chairman**. Thank you. Senator Graham.

Senator **Graham**. Mr. Chairman, I come out of a background which includes in part the development of a new town and one of the challenges in that is to try to think 50 years ahead of what you want this place to look like and function like and how will it serve people when it's completed.

Once you have established those types of objectives, then you can begin to decide we're going to begin with part A or part B as the first increment of development. I know you had an opportunity sometime ago to visit with us there.

Mr. **Greenspan**. It was quite impressive, Senator.

FUTURE OBJECTIVES

Senator **Graham**. Thank you. In the context of that, I'm interested in what you think the year 2000 objectives ought to be for America's financial institutions. Where should we be trying to go? Then we can decide whether we go there in one step or a thousand steps, but at least we will know when we have arrived at our destination.

Mr. **Greenspan**. Senator, it's very difficult to formulate other than generic legislation for a financial system which will stay in place for a protracted period of time, largely because consumer preferences are constantly changing and the technological capability of financial institutions to serve them is constantly advancing.

If somebody asked 30 years ago, literally, whether we would have the type of financial instruments or products which now proliferate in the markets, clearly the suggestion would have been that it was a forecast which had very small probability of occurring. It was just peculiar notions of what markets would eventually do.

I don't know what the markets will be doing with respect to financial structure in the year 2000. I do know that it will be very complex and the financial system will create an extraordinary array of products driven by consumer needs. Therefore, what is crucial to any generic financial system is that it grants very general powers and that it maintains safety and soundness in a very general way without endeavoring to specifically restrict the system to a long list of powers which, if implemented in today's environment, will surely be by the turn of the century half obsolete.

So that one either has to have in position a very general legislative vehicle or one which is presumed to be revisited periodically to update the system to the current environment.

So while I would say it's useful to think that far into the future, I don't think it is useful to think that far into the future with any great specificity because the chances of our being right are really quite small.

Senator **Graham**. You have stated that one of the objectives would be to have a system which optimized or maximized market responsiveness.

Mr. **Greenspan**. Yes.

Senator **Graham**. I think that is a significant statement of an objective which, if adopted, would drive a number of the immediate and incremental decisions.

Mr. **Greenspan**. Yes.

Senator **Graham**. How do you see in terms of looking at those objectives from a nationalistic standpoint what should be the objectives in the year 2000 relative to the degree of domestic control over domestic financial institutions?

Mr. **Greenspan**. Well, I think it's obligatory for us to maintain control over our domestic institutions in the same general context that exists today. I am only concerned that we don't so rigidify the statutes that the form of those institutions, even if they are competitive today, will cease to be so in the year 2000.

Senator **Graham**. Thank you.

The **Chairman**. Dr. Greenspan, in your November 18 appearance before the House Banking Committee you said, "That without the repeal of Glass-Steagall, banks' share of credit markets is likely to decline, as it already has in our measure of short and intermediate term business credit."

Why should that be a concern of the Congress if banks lose share of credit markets and what are the public policy consequences of this for our country?

Mr. **Greenspan**. Well, first of all, let me say that the reasons that that would occur are basically market forces, largely the issue of securitization or forms of securitization.

The **Chairman**. Because the Glass-Steagall Act keeps the banks out of securitizing loans?

Mr. **Greenspan**. Yes, but it basically eliminates the capability of essentially getting involved in security products generally. If that should occur—meaning that we don't repeal Glass-Steagall—and we gradually contract the banking function in this country, I'm not saying that the financial system will become inefficient. What I am saying is that we will be foregoing the extraordinary value that our commercial banking system has to this economy. The system of 14,000 banks is a tremendously important institutional framework with resources and personnel which would be scattered to different forms of institutions.

The cost to the economy in doing that is potentially significant and we should endeavor by all means to avoid that if we possibly can and repeal of Glass-Steagall, in my judgment, would succeed in holding these institutions in place.

The **Chairman**. Now as you know, American banks are engaging in securities activities abroad—we've mentioned that before—underwriting of corporate debt and equity securities that they cannot conduct in the United States because of Glass-Steagall.

To carry out such activities abroad, are U.S. banks using separate securities affiliates as set forth in S. 1886, The Financial Modernization Act? If not, do you recommend that S. 1886 be amended to require that they do so?

Mr. GREENSPAN. I think it's a major question which this committee is going to have to confront. At the moment, clearly, these securities affiliates do not have the requirements that are implicit in S. 1886. They function quite well. They have done quite well.

The CHAIRMAN. Are you saying that banks do use securities affiliates abroad or they don't?

Mr. GREENSPAN. Well, the major ones do. It's not the issue of holding company affiliates per se that's an issue, but the question really of the symmetry of regulation that does not exist in S. 1886.

Currently, what we are supporting is a series of safeguards between securities affiliates of bank holding companies domestically and banks and a number of those safeguards do not apply overseas. Very specifically, lending to the the securities affiliate by the bank, is not prohibited currently for securities affiliates or even subsidiaries of banks in the securities area abroad.

As I said, it's a problem of symmetry. But I am reluctant myself to say that we must change the foreign operations to match the domestic because the foreign operations have functioned really quite well. I think it is an issue, however, of trading off the question of symmetry versus the proposition to which I hope we all subscribe—if it ain't broke, don't fix it. And as far as I can judge, the securities operations of American banks abroad ain't broke.

The CHAIRMAN. I want to thank you, Chairman Greenspan, for a superlative appearance before the committee, both in your opening statement and in your thoughtful and effective answers to our questions. Thank you very much.

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

Senator RIEGLE. Mr. Chairman, we've got probably 4 or 5 minutes here before I'll have to leave and also make this vote.

I'm concerned about the possibility of tie-in sales and that kind of problem. Do you envision a geographic separation? We had a person in representing a major bank holding company the other day who has really taken and set up one-stop financial shopping and actually has a bank that's sort of a business in the round where you've got one office that sells insurance and another office that sells real estate services and so forth right around presumably a securities office as well as the commercial banking office.

Do you feel that it's important one way or the other that these things either be in the same geographic location or do you think the securities activity ought to be separated from the commercial banking activity so that you really minimize the likelihood of a tie-in in reality or pressure?

Mr. GREENSPAN. Well, this is a problem which I don't think we're ever going to solve, which is the issue of the advantages of joint marketing on the one hand and pressure on the other, pressure being a somewhat very difficult issue to define.

My own impression—and I may be mistaken on this—is that tie-in sales are really a very small part of any operation and it is not a general practice, especially in the financial area. But I can understand concerns that may exist from that and I would certainly think that endeavors should be made to minimize the possibility of tie-in sales occurring but I would not wish to see us become so concerned about the issue that we would eliminate what consumers really want. In other words, there is clear evidence that one-stop type of shopping is something which consumers find of value.

Senator RIEGLE. Well, let me tell you the one concern I have because I hear from a lot of business people. Michigan is the eighth largest State and we've got a lot of business people of all sizes up and down the range, and I find that as smaller-scale business people establish and maintain their banking relationships, it's of a real choke point if things get tough all of a sudden and it's hard to get credit or it's hard to go and finance something. And they feel—many of the business people that I talk to feel that they don't have very much leverage in those relationships and they don't want to surrender what they have. And I think they feel, at least some that I've talked to, as if they would feel in some cases like they would have to be accommodating to the bank because they want the bank to be accommodating to them.

I don't think this is a fictitious thing. I think it's a real thing.

Mr. GREENSPAN. Well, the interesting question is: There's a distinction between people who are being forced inappropriately and a negotiating position. It's very difficult to draw the line. It's very clear in most business relationships. People have different bargaining power and the question always gets down to whether there was coercion involved, whether there was a tie-in.

Senator RIEGLE. I have found, generally speaking, though, that the lender in most situations has more bargaining power than the borrower. Now there are times when that's not so.

Mr. GREENSPAN. I would agree with that.

Senator RIEGLE. Let me move to one other thing and that's bank profitability. When you look at bank profitability across the country, from the big money center banks on out to the smaller banks across the country, do you see a serious bank profitability problem and do you see this as an answer for the bank profitability problem if you see one, or are we talking here more about financial structure, efficiency of services, capital-raising capability as apart from just the sheer ability to be sufficiently profitable as a commercial bank?

Mr. GREENSPAN. It's the latter. I think that there are considerable financial problems in banks, but at the moment we do not yet see conclusive evidence that underlying bank profitability per se has undergone significant erosion, meaning that we can account for most of the actual reported decline in bank profits by problems in quality of loans, by technical issues which are not long term.

I should point out, however, that if the securitization issue, the problem that we have been discussing about the shrinking of the intermediation role—continues, it is inevitable, as I see it, that commercial banking profitability will decline.

There is a distinction between the forecast which I believe is reasonably assured in the future and current analysis. Our recommendation with respect to Glass-Steagall does not relate to concerns about profitability per se. It concerns, as you put it, Senator, the future structure of banking and the most efficient system that we think can be devised.

Senator RIEGLE. I thank you on behalf of the committee and we will be talking further about these matters.

Mr. **Greenspan**. Thank you.

Senator **Riegle**. The committee is adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

LEGISLATIVE PROPOSALS TO RESTRUCTURE OUR FINANCIAL SYSTEM

WEDNESDAY, DECEMBER 2, 1987

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Senate Dirksen Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dodd, Sasser, Graham, Garn, Heinz, D'Amato, Hecht, Chafee, and Karnes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The Chairman. This morning, we will hear Under Secretary of the Treasury, George Gould, present his view on financial restructuring, with particular attention to the three legislative proposals now before the committee—S. 1886 by Senator Garn and myself, S. 1891 by Senators Graham and Wirth, and a new bill introduced yesterday by Senators Cranston and D'Amato, S. 1905.

Then we will receive testimony from a panel which includes William Haraf of the American Enterprise Institute, and Robert Litan of the Brookings Institution.

The expiration of the moratorium is 3 months away; Congress has to move quickly.

These three bills show that this committee is making progress in an effort to meet that deadline. At the same time, there is a concern that some of the proposals will be difficult for a concensus to be formed before the moratorium expires.

In fact, I'm afraid that comprehensive could be a synonym for stalemate. We can no longer afford delay. If we pass no legislation before March 1, we will not freeze the system in place, we will simply pass the baton of financial restructuring to regulators and courts and lawyers.

I think the comprehensive proposal before us merits consideration. Enacting the legislation that Senator Garn and I have drafted in no way precludes the consideration of these more ambitious proposals.

Our bill seeks to repeal Glass-Steagall and permit banks to engage in securities activities through an affiliate, so we lead to the other bills. We take a first step in this bill; it need not be the last if the Congress wants to go further in the future.

Nor is the Congress compelled to move further down the road if it does not want to. But, it is important to assert congressional control over the restructuring of the financial services industry. It is time to bring our financial laws up-to-date while, at the same time, providing specific safeguards to preserve safety, prevent conflicts of interest and enhance competition.

[The complete prepared statement of Chairman Proxmire follows:]

OPENING STATEMENT
CHAIRMAN WILLIAM PROXMIRE
HEARING ON FINANCIAL MODERNIZATION
DECEMBER 2, 1987

This morning we will hear Under Secretary of the Treasury George Gould present his views on financial restructuring with particular attention to the three legislative proposals now before the committee. S.1886, by Senator Garn and myself; S. 1891 by Senators Graham and Wirth; and a new bill, introduced yesterday by Senators Cranston and D'Amato. Then we will recieve testimony from a panel which includes William Haraf of the American Enterprise Institute and Robert Litan of the Brookings Institution.

With the expiration of the moratorium just 3 months away, the Congress has to move now. These three bills show that this committee is making progress in an effort to meet that deadline.

But at the same time I am concerned that some of the ambitious provisions in the Graham-Wirth and Cranston-D'Amato bills are so broad and controversial that it will be difficult for a consensus to be formed before the moratorium expires. In effect, I am afraid that comprehensive could be a synonym for stalemate.

We can no longer afford delay. If we pass no legislation before March 1st we will not freeze the system in place. We will simply pass the baton of financial restructuring to the regulators, the courts, and the loophole lawyers.

I think the comprehensive proposals before us merit consideration. Enactment of the legislation that Senator Garn and I have drafted in no way precludes ongoing consideration of these more ambitious proposals. Our bill seeks to repeal Glass-Steagall to permit banks to engage in securities activities through an affiliate. So does each of the other bills. We take the first step in this bill but it need not be the last if the Congress wants to go further in the future. Nor is the Congress compelled to move further down the road if it does not want to.

But it is important to assert Congressional control over the restructuring of the financial services industry. It is time to bring our financial laws up-to-date while at the same time providing specific safeguards to preserve safety, prevent conflicts of interest, and enhance competition.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman. In the interest of the witnesses' time, I will simply say "Amen" to your statement. And we will proceed.

The CHAIRMAN. Thank you, Senator Garn.

Senator D'Amato.

OPENING REMARKS OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, let me first ask if it will be permitted to submit a statement as if read in its entirety in the interest of time.

The CHAIRMAN. Without objection, so ordered.

Senator D'AMATO. Thank you, Mr. Chairman.

Second, let me say that it was certainly not out of a lack of interest yesterday when I left the hearing, but I had an important mark-up which I had to attend.

And, today, as cochairman of the Joint Caucus, which is convening at this very moment, at 10 o'clock, I will of necessity have to be at that hearing. So I will not be able to be here and to ask the various questions that I would like to place in the record.

I'd ask permission of the chairman that I submit these questions, and I would ask the Assistant Secretary of the Treasury, Mr. Gould, to respond.

The CHAIRMAN. Without objection, I'd be delighted to pass those on.

Senator D'AMATO. Third, Mr. Chairman, let me suggest to you and the members of this committee that I take strong objection to those staffers who will talk anonymously to the media, and who will ascribe motivations to legislation that this Senator has introduced, along with Senator Cranston, and attribute those motivations as an attempt to forestall or do nothing, or continue the moratorium.

I think they're mean-spirited, counterproductive and I resent them. I'm prepared to go further. I want to suggest to you that I have never impugned either directly or indirectly any of my colleagues and their motivations when people have reason to have differences of opinion.

But I take very, very real exception and offense to a staffer undertaking this kind of activity not only with the media, but with everyone and anyone he or she can come in contact with. I think it's wrong.

I don't think that the chairman conducts himself in that manner. I don't think staffers should. This is the first time in 7 years that I've ever found it necessary to speak in this kind of manner.

Let me say something about the legislation that Senator Cranston and I introduced. If we don't have the political courage to do the real job, then that's our fault. I think we should look at all the legislative proposals based on their merit and not just say blanketly, oh, well, this just simply can't be.

If there are objections to it, legitimate, fine. Vote against it. Knock it down. Work against it. Work for change. But, just simply to attribute and to say this is just a legislative initiative that is designed to derail or to continue the status quo, No. 1, I want to tell you that's not this Senator's motivation.

No. 2, I think that there are a number of issues in that legislation that have been submitted by four of my colleagues. Two pieces of legislation, that which you and Senator Garn have put forth, and that which Senator Wirth and Senator Graham have put forth are not adequately dealt with.

For example, if we're going to allow banking institutions to undertake through a separate sub securities activities, fine, so be it. But what about the evenhandedness of saying that, therefore, those other institutions, securities institutions, et cetera, will have that opportunity as it relates to banking activities.

There's a whole host of things. We talk about evenhandedness and fairness, and what about being under the same set of rules as it relates to those who will regulate these kinds of activities?

So there are very real, honest disagreements. I don't share the view of some that this cannot be done if we really work at it by that March 1 deadline, and that we can't arrive at a very real concensus.

So, Mr. Chairman, I wanted to state for the record this Senator's motivation was not to forestall legitimate initiatives in this area and to deal with the problem of the inadequacies of Glass-Steagall as it relates to the present market conditions.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT BY SENATOR ALFONSE D'AMATO
DECEMBER 2, 1987

Alfonse D'Amato

THIS MORNING MARKS THE SECOND IN OUR MOST RECENT SERIES OF HEARINGS ON PROPOSALS DESIGNED TO RESTRUCTURE THE FINANCIAL SERVICES SYSTEM. IN HIS TESTIMONY THIS MORNING, UNDERSECRETARY GOULD URGES US TO BE "SKEPTICAL OF THE DEFENDERS OF THE STATUS QUO." I AGREE WITH HIM, BUT WOULD ALSO ADD THAT WE SHOULD BE EVEN MORE SKEPTICAL OF PIECEMEAL REFORM PACKAGES THAT DO LITTLE TO, AS UNDERSECRETARY GOULD SO CORRECTLY NOTES IN HIS TESTIMONY, "MODERNIZE OUR NATION'S FINANCIAL SERVICES INDUSTRY TO BETTER SERVE CONSUMER AND BUSINESS."

YESTERDAY IN FED CHAIRMAN GREENSPAN'S REMARKS AND THIS MORNING IN SECRETARY GOULD'S TESTIMONY THEY APPARENTLY HAVE SETTLED FOR THE INCREMENTAL REFORMATION OF THE FINANCIAL SERVICES INDUSTRY. THEY WOULD START WITH SECURITIES POWERS AND THEN PROCEED ON AN INCREMENTAL BASIS TO EXPAND THE POWERS OF BANKS INTO OTHER PRODUCT LINES. TO SUPPORT THEIR CLAIM THAT BANKS CAN BE TRUSTED WITH THE NEW SECURITIES POWERS, THEY CITE THE SUCCESSFUL EXPERIENCE OF BANK UNDERWRITING IN FOREIGN MARKETS. IF THE BANKS HAVE BEEN SO SUCCESSFUL IN FOREIGN MARKETS, WHY SHOULD WE PROLONG THE PERIOD OF EXPERIMENTATION BY A LIMITED RESTRUCTURING IN OUR DOMESTIC MARKETS. THE INCREMENTAL APPROACH FORCES BANKS TO REENACT THEIR SUCCESSES ABROAD WHEN WE SHOULD BE ADDRESSING BROADER REFORM. THE

INCREMENTAL APPROACH SEEMS INCONSISTENT WITH A MAJOR OBJECTIVE OF FINANCIAL MODERNIZATION SINCE THE "MODERNIZATION" MOVEMENT IS AIMED AT ENHANCING THE ABILITY OF OUR FINANCIAL SERVICES INDUSTRY TO COMPETE ABROAD.

IF BANKS HAVE TRULY PROVEN THEMSELVES IN THE FOREIGN MARKETS, THEN WE SHOULD SERIOUSLY CONSIDER THE NEXT STEP OF BROADER REFORM OF THE ENTIRE FINANCIAL SERVICES INDUSTRY - SUCH REFORM IS CONTEMPLATED BY THE DEPOSITORY INSTITUTION AFFILIATION ACT THAT SENATOR CRANSTON AND I HAVE INTRODUCED. IF WE ARE GOING TO ATTRACT MORE CAPITAL INTO OUR BANKING AND S&L INSTITUTIONS SO THAT THEY CAN COMPETE AT HOME AND ABROAD, WE WILL NOT ACCOMPLISH THIS GOAL BY SIMPLY EXPANDING BANKS SECURITIES POWERS. WE MUST FIND WAYS TO ATTRACT NEW AND ADDITIONAL SOURCES OF CAPITAL INTO THE BANKING SYSTEM. UNLIKE THE OTHER PROPOSALS BEFORE THE COMMITTEE, THE DEPOSITORY INSTITUTION AFFILIATION ACT DOES THIS.

IN ADVOCATING THE REFORM EMBODIED IN THE DEPOSITORY INSTITUTION AFFILIATION ACT, I FIND MYSELF IN A UNIQUE POSITION. LAST MONTH, I WAS VIEWED AS A PROPONENT OF THE VERY STATUS QUO WHICH GEORGE GOULD REBUKES. TODAY, I AM VIEWED AS THE SPONSOR OF A SWEEPING PROPOSAL. WHY THE CHANGE?

FIRST, THE MEMBERS OF THIS COMMITTEE MADE A PLEDGE TO CONSIDER, AND HOPEFULLY ENACT, COMPREHENSIVE REFORM OF THE FINANCIAL SERVICES INDUSTRY PRIOR TO THE EXPIRATION OF THE MORATORIUM IMPOSED BY THE COMPETITIVE EQUALITY BANKING ACT.

WHILE I DON'T SEE ANY REASON TO EXTEND THE MORATORIUM, I DO NOT DISCERN ANY COMPELLING REASON TO LIMIT OUR DISCUSSION OF "COMPREHENSIVE REFORM" TO A GRANT OF A FEW UNDERWRITING POWERS TO BANKS.

SECOND, IN MY JUDGMENT, THE PREVIOUS DEREGULATION PROPOSALS PLACED BEFORE THE COMMITTEE DID NOT ADEQUATELY ENSURE THE SAFETY AND SOUNDNESS OF THE FINANCIAL SYSTEM. I BELIEVE THAT DEREGULATION OR RESTRUCTURING COUPLED WITH FEDERAL DEPOSIT INSURANCE COULD LEAD TO MAJOR PROBLEMS. FOR EXAMPLE, DEPOSIT INSURANCE MIGHT TEMPT SOME BANKERS TO TAKE ON RISKY VENTURES THEY WOULD NOT GAMBLE ON WITHOUT INSURANCE. I COULD NOT AND CANNOT SUPPORT PRODUCT DEREGULATION THAT RESULTS IN THE EXPLOITATION OF INSURED DEPOSITS IN A WAY THAT LEADS TO THE ADOPTION OF RISKY ACTIVITIES WHICH ARE ESSENTIALLY UNDERWRITTEN BY THE TAXPAYER AND THE DEPOSIT INSURANCE FUNDS. I BELIEVE THAT THE DEPOSITORY INSTITUTION AFFILIATION ACT PREVENTS SUCH AN EXPLOITATION BY ADEQUATELY INSULATING THE BANK FROM THE OTHER FINANCIAL AND COMMERCIAL AFFILIATES OF THE HOLDING COMPANY CREATED UNDER THAT BILL.

I WOULD HOPE THAT UNDERSECRETARY GOULD AND THE MEMBERS OF THE COMMITTEE WILL GIVE SERIOUS CONSIDERATION TO THIS PROPOSAL AS WE PROCEED IN OUR DELIBERATIONS ON MODERNIZING THE LAWS REGULATING OF FINANCIAL SYSTEM.

The CHAIRMAN. Senator D'Amato, I want to thank you for your straightforward and typically honest and blunt statement. It was very good. There's nothing that you've said with which I disagree. Your legislation is going to be considered fully, carefully before this committee.

You, as a member of the committee and Senator Cranston have every opportunity to offer whatever amendments you wish.

But I think we all are aware, as you are and as you said so well, that we should act before March 1.

Senator Garn.

OPENING REMARKS OF SENATOR GARN

Senator GARN. Mr. Chairman, I might just respond to the Senator from New York. During the hearings yesterday as I stepped out, I was asked the question if the legislation introduced by you and Senator Cranston was for the purpose of a stall.

And I said, "Well, I don't know where you're getting that from because, as a matter of fact, I told some of the groups who were interested in that piece of legislation, despite the fact that Senator Proxmire and I were introducing a bill, that I was willing to introduce that bill by request—although not for sponsorship.

So, as far as the membership of the Senate, you have no concern because if you had not put that bill in, I would have by request, so that it would have been considered along with the other bills.

So I told that particular reporter that it certainly was not a stall because the bill would have been before this committee in any event, because I was willing to introduce it by request, although without my endorsement.

I think the Senator from New York is well aware after all the years of being in the trenches with me that I prefer much broader legislation, and that has been on the record for many, many years.

So I think everyone who is familiar with the process would realize that, over the years, legislation that either Senator Proxmire or I have introduced when we were chairman became quite different after going through the process. So all three proposals are before this committee for testimony to be received, and I would expect that whatever we pass will be different than what has been introduced.

I think the important point that both you and the chairman have made is that we ought to act and complete our work by March 1, whatever the final product of our work is.

Senator D'AMATO. I thank the chairman. And I certainly thank Senator Gran. As I indicated, I find it distressful when staff undertakes these assumptions without even having the benefit of coming to the Senator and maybe raising some questions, or with my staffers, but jumping to the conclusion; because I do believe that we'll find that in the fullness of time, many of those provisions that Senator Cranston and I have supported in our bill will be enacted into law and, hopefully, before March 1.

It is a broader, more comprehensive treatment of the whole area. And I think we should not go about it in a haphazard manner.

You've been very gracious in extending to me this opportunity to make my thoughts known. I would hope that this would dampen those who work behind the color of the public forum and domain in ascribing motivations to those of us who are attempting to carry out what we see as an important mission. And I think that we are embarked upon an important mission.

I commend both you and the chairman for undertaking this legislative initiative.

The **Chairman**. Thank you, Senator D'Amato. At this point, may I ask unanimous consent that statements of Senators Dixon and Heinz be included in the record.

Alan J Dixon

DECEMBER 2, 1987

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
BANKING REFORM ISSUES

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE BANKING COMMITTEE CONTINUES ITS HEARINGS ON BANKING REFORM LEGISLATION. THERE ARE NOW THREE MAJOR PROPOSALS BEFORE THE COMMITTEE: THE PROXMIRE-GARN BILL, THE WIRTH-GRAHAM BILL, AND, JUST INTRODUCED YESTERDAY, THE D'AMATO-CRANSTON BILL.

THESE PROPOSALS RAISE A FUNDAMENTAL QUESTION: WHETHER IT IS BEST TO TRY TO ADDRESS ALL THE REFORM ISSUES AT ONCE IN A SINGLE COMPREHENSIVE BILL OR WHETHER TO PROCEED IN A STEP-BY-STEP FASHION.

THE PROXMIRE-GARN PROPOSAL PARTIALLY REPEALS THE GLASS-STEAGALL ACT. IT IS A LANDMARK PROPOSAL. YET IT IS THE NARROWEST OF THE THREE MAJOR PROPOSALS BEFORE THE COMMITTEE.

FEDERAL RESERVE BOARD CHAIRMAN ALAN GREENSPAN TESTIFIED BEFORE THIS COMMITTEE YESTERDAY IN FAVOR OF THE PROXMIRE-GARN PROPOSAL AND IN FAVOR OF THE KIND OF STEP-BY-STEP APPROACH THAT IT REPRESENTS. I HAVE AN OPEN MIND ON THE QUESTION OF HOW BEST TO PROCEED, BUT I WOULD LIKE TO MAKE TWO SIMPLE POINTS.

FIRST, I DO NOT THINK WE SHOULD LOSE SIGHT OF HOW AMBITIOUS A PROPOSAL THE PROXMIRE-GARN PROPOSAL IS. THE SENATE HAS NEVER BEEN ABLE TO GET THE HOUSE TO ADDRESS EVEN NARROWER BILLS THAT EXPANDED THE RANGE OF ASSET POWERS AVAILABLE TO BANK HOLDING COMPANIES, AND THIS BILL IS MUCH MORE AMBITIOUS THAN THOSE PAST PROPOSALS WERE. THE PROXMIRE-GARN PROPOSAL RAISES A NUMBER OF ISSUES THAT THE COMMITTEE MUST CONSIDER VERY CAREFULLY. I AM ONE WHO HAS VOTED FOR NEW ASSET POWERS IN THE PAST. I KNOW HOW DIFFICULT IT WAS FOR THE COMMITTEE TO ACT ON THAT BILL, AND IT WAS MUCH NARROWER THAN ANYTHING BEFORE THE COMMITTEE NOW.

THAT LEADS ME TO MY SECOND POINT: I WONDER WHETHER THERE IS ENOUGH TIME TO ACT ON A COMPREHENSIVE BILL. IT IS NOW DECEMBER AND I HOPE AND EXPECT THAT CONGRESS WILL ADJOURN FOR THE YEAR SOMETIME WITHIN THE NEXT THREE WEEKS. THE MORATORIUM EXPIRES ON MARCH 1ST, 1988, LESS THAN 90 DAYS FROM NOW. I WOULD LIKE TO SEE THE COMMITTEE ACT BY THEN.

IN 1984, THE COMMITTEE WAS NOT ABLE TO ACT UNTIL JUNE, AND IT WAS NOT ABLE TO GET THE BILL TO THE FLOOR UNTIL SEPTEMBER, LESS THAN 30 DAYS BEFORE CONGRESS ADJOURNED. THE BILL THEREFORE DIED. I DO NOT WANT TO SEE THAT HAPPEN THIS YEAR. I WOULD HOPE THE COMMITTEE WOULD SEND A BILL TO THE HOUSE IN TIME TO GIVE THE HOUSE A REAL OPPORTUNITY TO ACT ON IT. I DO NOT THINK THE COMMITTEE SHOULD REPORT A BILL AS AN ACADEMIC EXERCISE. I THINK WE MUST KEEP OUR EYE CLEARLY ON THE BALL, AND TRY TO ACT ON A PROPOSAL THAT HAS A REAL CHANCE OF BECOMING LAW.

I DO NOT ARGUE NOW THAT THE HOUSE COULD NOT BE PERSUADED TO ACT ON A COMPREHENSIVE BILL IF THIS COMMITTEE WERE TO ACT ON IT IN AN EXPEDITIOUS MANNER. I DO HOPE, HOWEVER, THAT ALL MY

COLLEAGUES WILL KEEP THE HISTORY OF BANKING REFORM LEGISLATION CLEARLY IN MIND AS WE TRY TO FIND A CONSENSUS WITHIN THE COMMITTEE ON HOW BEST TO ACT.

I THINK THE COMPREHENSIVE PROPOSALS MAKE AN EXTREMELY IMPORTANT POINT. I THINK WE MUST HAVE SOME IDEA OF WHAT WE WANT THE OVERALL STATUTORY FRAMEWORK FOR THE FINANCIAL SERVICES INDUSTRY TO LOOK LIKE AS WE MOVE FORWARD. I LOOK FORWARD TO WORKING WITH MY COLLEAGUES ON THIS COMMITTEE IN THE COMING DAYS AS THE COMMITTEE ATTEMPTS TO REACH A DECISION ON THE QUESTION OF WHETHER TO PROCEED IN A STEP-BY-STEP OR A COMPREHENSIVE MANNER, AND ON THE MANY OTHER ISSUES RAISED BY THE LEGISLATIVE PROPOSALS NOW BEFORE US.

STATEMENT OF THE HONORABLE JOHN HEINZ
BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
DECEMBER 2, 1987

MR. CHAIRMAN, I JOIN YOU IN WELCOMING OUR WITNESSES TODAY AS THE COMMITTEE CONTINUES ITS EXAMINATION OF WHAT ARE NOW THREE PROPOSALS TO RESTRUCTURE THE BANKING SYSTEM.

IN THE CONCLUSION OF HIS BOOK, "WHAT SHOULD BANKS DO?" MR. LITAN MAKES THE FOLLOWING OBSERVATIONS:

> "ALTHOUGH IT MAY TAKE TIME, LIBERALIZATION OF THE CURRENT RESTRICTIONS ON FINANCIAL PRODUCT LINE DIVERSIFICATION IS INEVITABLE. THE INVASION INTO TRADITIONAL BANKING ACTIVITIES BY OTHER TYPES OF ORGANIZATIONS WILL EVENTUALLY GROW TO THE POINT WHERE THE STATES AND THEN CONGRESS WILL ATTEMPT TO LEVEL THE PLAYING FIELD.
>
> THE CRITICAL POLICY QUESTION ... IS WHETHER POLICYMAKERS WILL AT THE SAME TIME ACT TO LIMIT THE RISKS THAT FINANCIAL PRODUCT DEREGULATION COULD POSE."

THERE LIES THE DILEMMA, MR. CHAIRMAN. CAN WE CRAFT A NEW STRUCTURE THAT WILL ENHANCE THE BANKING INDUSTRY'S COMPETITIVE POSITION IN THE FINANCIAL SERVICES MARKETPLACE WITHOUT ABDICATING THE INHERENT "PUBLIC CHARACTER" OF ITS INSTITUTIONS? MOREOVER, CAN WE DO IT WITHOUT SACRIFICING THE COMPETITIVE POSITIONS OF OTHER FINANCIAL SERVICES ORGANIZATIONS?

I NOTE THAT ALL OF THE BILLS ADDRESS THIS QUESTION BY PROPOSING A HOLDING COMPANY STRUCTURE OF SOME SORT TO ENSURE CORPORATE SEPARATENESS OF THE BANK

FROM THE RISKS OF THE NONBANK SUBSIDIARIES. MY CONCERN — ASIDE FROM MY LONGSTANDING RESERVATIONS REGARDING THE MIXING OF BANKING AND COMMERCE — IS WHETHER SUCH INTEGRATION, ALBEIT THROUGH SEPARATE SUBSIDIARIES, WILL LEAD TO THE UNDESIRABLE PROPAGATION OF THE DEPOSIT INSURANCE GUARANTEES AND ITS CORRESPONDING HAZARDS. EVEN IF WE INSULATE THE BANK FROM THE NONBANK SUBSIDIARIES, CAN WE REMOVE THE "SUBSIDY" PROVIDED BY DEPOSIT INSURANCE THAT WOULD PROPAGATE TO THE NONBANKING ACTIVITIES OF THE ORGANIZATION SHOULD PROBLEMS DEVELOP?

THIS IS A CRITICAL ISSUE, MR. CHAIRMAN, AND ONE WHICH I WOULD HOPE THE WITNESSES WILL ADDRESS IN THEIR TESTIMONY TODAY.

Chairman Proxmire. Secretary Gould, we're delighted to have you here. Go right ahead, sir.

STATEMENT OF GEORGE D. GOULD, UNDER SECRETARY OF FINANCE, DEPARTMENT OF THE TREASURY

Mr. Gould. Mr. Chairman, Senator Garn, members of the committee, I welcome this opportunity to appear before you in support of S. 1886, the Financial Modernization Act.

There is a still urgent need to modernize our Nation's financial services industry to better serve consumers and business. Your legislation is a great first step toward a more rational financial structure.

I also want to commend this committee for its role in recapitalizing the Federal Savings and Loan Insurance Corporation. That important legislation was made possible by the willingness of the Congress and the administration to strike a compromise for the good of the public.

It is my hope that this self-same spirit of compromise will set the tone for the important business we now have before us. If so, I am confident that this committee will agree that S. 1886 provides the proper starting point for broader reform.

Mr. Chairman, the administration applauds the bipartisan leadership to modernize our system that you and Senator Garn have demonstrated over the years, not only in cosponsoring this procompetitive and proconsumer legislation, but also in your repeated public assurances upholding the clear statement of congressional intent in the Competitive Equality Banking Act, that the moratoria on new products and services will not be extended beyond next March.

Mr. Chairman, you have also asked us for our comments on the Financial Services Oversight Act, S. 1891, introduced by your colleagues, Senators Wirth and Graham.

While the sponsors obviously put a great deal of thought and effort into drafting the approach first outlined by New York Federal Reserve Bank President, Jerry Corrigan, I will be unable to make any specific comments at this time because the administration does not yet have a formal position on this new legislation.

As soon as the administration reaches a position on the Financial Services Oversight Act, I would be pleased to respond for the record.

As we proceed, Mr. Chairman, we should be skeptical of the defenders of the status quo, who will argue that the recent volatility in the stock market precludes the need to update our antiquated banking laws. It does not.

Some observers will try to equate the risks involved with investing in the stock market, a risk we acknowledge up front, with the alleged riskiness of engaging in new activities. They should not.

THE CHANGING WORLD MARKETPLACE

Recent market events, however, have underscored the need for the proper fundamentals, such as adequately and separately capitalized firms and vigilant supervision to maintain the integrity of the Federal safety net.

These same real world events should not be used as an excuse or stand in the way of reforming laws to both greater competition and consumer benefits.

Like it or not, the financial services world is changing all around us. In the past several years, thousands of pages of congressional testimony before this committee have recorded these changes.

Today's products were not available yesterday; tomorrow's services are not yet contemplated. Technological advances, enhanced access to information and growing customer sophistication have combined to create a demand for new products and services deliverable on a local, national, and international scale.

Near perfect substitutes for traditional banking products found their genesis in powerful economic forces, such as accelerating inflation and in statutory restrictions dating back to a time few of us really remember.

Mr. GOULD. All right, sir.

Many U.S. firms fund themselves just as efficiently overseas as they do in this country. And even some government sponsored entities have sold securities in foreign markets. My prepared text elaborates on this point in greater detail.

The need to modernize our financial services industry has spawned a large number of reform proposals, including S. 1886 and S. 1891. And, just yesterday, Senator D'Amato and Senator Cranston introduced S. 1905, the Depository Institution Affiliation Act. They are all worthy of serious consideration.

These various reform proposals, though different in structure and the degree of change advocated, share several common elements. All seek to promote greater competition in the delivery of financial services. All seek benefits from this new competition for the end users—consumers, business and government.

All contain safeguards to prevent unfair competition and conflicts of interest. And all provide for extensive supervisory oversight. These proposals are timely and thought-provoking. They demonstrate clearly that the Congress has a wide range of alternatives before it.

One of the most striking features in most of these reform proposals is the recommendation that the dated, artificial restrictions between commercial and investment banking ought to be reduced or even eliminated.

A FIRST STEP TOWARD COMPREHENSIVE RESTRUCTURING

The Financial Modernization Act clearly recognizes this common thread. Amending the Banking Act of 1933, the so-called Glass-Steagall Act, is the proper first legislative step.

Our mutual focus must be on the needs of consumers and not on the self-serving pleas of special interests seeking Government's help to thwart competition.

For the 10 reasons I outlined in my prepared text, the administration supports modernizing the Banking Act of 1933 to permit the affiliation of commercial and investment banking, subject, of course, to the watchful eye of the proper supervisory agencies.

Let me just mention two of those reasons this morning. First, competition is enhanced and concentration is avoided. The Glass-

Steagall Act is essentially protectionist legislation and, in the long run, artificial economic barriers do more harm than good.

Competition is a prerequisite for the advancement of economic well-being in our society and long-run safety and soundness.

I particularly want to direct your attention to the figures in my prepared testimony highlighting the high degree of concentration of the securities industry today. Simple facts about this highly concentrated industry were recently compiled in an excellent study by the House Government Operations committee under the supervision of subcommittee Chairman Barnard.

I urge you to review that committee's findings for yourself.

Second, consumer's benefit. Businesses, municipalities, consumers and the economy as a whole would benefit substantially from enhanced competition between the commercial banking and the securities industries. There would be a greater variety of products, more convenience, and lower costs. For example, in recent testimony before this committee, associations of ultimate users, the National Governors Association and the National League of Cities strongly supported allowing commercial banking organizations to underwrite municipal revenue bonds.

Similarly, the National Association of Realtors and the National Association of Home Builders strongly supported commercial bank underwriting and dealing in mortgage-backed securities as a means of lowering the cost of housing finance.

Consumers of all income levels and types should benefit as well. More investment opportunities should be available for ordinary consumers as banking organizations of all sizes offer more—and hopefully more efficient and beneficial—products and services. The ability of banks of all sizes to organize, sponsor and sell mutual funds is another example of how "ordinary" consumers in every community in this country could benefit by having more investment opportunities available. These are the kind of new opportunities for consumers that Congress cannot afford to ignore.

As the committee considers its debate and advances legislation, I respectfully want to suggest a number of guiding principles that ought to serve as the foundation for your deliberations.

First and foremost, as I mentioned earlier, insured depositors ought to be protected fully. We need to preserve the option for safe savings instruments for small savers.

Second, the Federal safety net should not be extended beyond insured depository institutions; securities affiliates ought to be viewed legally, publicly, and financially as separate units for safety and soundness reasons.

Third, the functional regulation that characterizes our financial system should be preserved and continued; thus, depository institutions will be regulated by Federal and State banking agencies while securities firms will be regulated by the SEC and State securities administrators.

Finally, the historic right of States to authorize activities for their State-chartered institutions is another principle worth maintaining and should not be preempted lightly to enforce a single national rule; certain national prescriptions may be appropriate for the conduct of new activities, but we should acknowledge the real benefits—such as product innovation—that flow from our dual banking system.

THE FINANCIAL MODERNIZATION ACT OF 1987

The administration applauds your yeoman efforts, Mr. Chairman, to work with us, Senator Garn and the Federal bank regulators to craft legislation that truly serves the public interest. The Financial Modernization Act is worthy of strong bipartisan support of the Congress. Not only is it procompetitive and proconsumer, as I indicated at the outset, but it also adheres to the high standards of safety and soundness which both the administration and the Congress share.

The fundamental structure of the Financial Modernization Act can be traced to the administration's first proposals to modernize our banking laws through a holding company format and to the legislation which Senator Garn spearheaded through the Senate in 1984. Many of the safeguards we suggested then and now have been incorporated and, in some important instances, enhanced in this legislation.

Title I amends section 20 and 32 of the Glass-Steagall Act to permit the affiliation of commercial and investment banking in a holding company structure. Commercial banking organizations would be allowed to have a securities affiliate, and a holding company that is 80 percent in the securities business would be able to acquire a commercial bank.

New securities affiliates are required to be separately capitalized. That capital would not be counted as part of the bank's required capital. This provision should go a long way toward alleviating concerns about increased risk from engaging in new activities, assuming, of course, that capital requirements established by the regulators are sufficient.

Entry into new securities activities would be monitored closely by the regulators with both the SEC and the Board of Governors of the Federal Reserve playing a major role to assure that new entrants have the requisite managerial talent and financial strength.

Numerous consumer and safety and soundness safeguards are contained in S. 1886 to assure a financial marketplace that is both efficient and safe. Because of these safeguards, the Federal safety net should in no way be jeopardized and, because of the holding company format and the use of separately capitalized affiliates, clearly, is not expanded. The testimony you will receive from the Federal bank regulators will concur in this judgment.

Full and proper disclosure is an important safeguard in the bill. Securities affiliates, for example, must disclose to their consumers that their obligations are in no way backed by their affiliate bank or insured by the FDIC, a major part of the Federal safety net I have mentioned. Similarly, a bank cannot express an opinion on securities being sold by its securities affiliate without disclosing that its affiliate is selling that security. In short, proper disclosure is a key element in consumer protection in this area.

Lending between a bank and its securities affiliates is also prohibited as a general rule, with an exception for fully secured intrabank loans for the purpose of clearing Government securities.

While many observers can argue that the existing safeguards contained in sections 23A and B of the Federal Reserve Act are sufficient to control lending between a bank and a securities affiliate, it can be argued that the requirements of the bill would reduce risk and prevent conflicts of interest in the credit granting role that banks perform.

Moreover, the securities affiliate cannot sell securities to the bank or its trust accounts during the underwriting period or for 30 days thereafter. Similarly, the securities affiliate cannot otherwise sell securities to the bank or its trust accounts, unless the sale is at an established market price. Thus, there are additional checks on any potential conflicts of interest, real or otherwise.

One area, however, where we do have reservations is in the area of federalism and states' rights. Section 107, in effect, removes the exemption from the Glass-Steagall Act for subsidiaries of freestanding State-chartered, nonmember banks, an exemption recently affirmed by the Supreme Court. While other provisions in the bill are designed to ease the formation of holding companies by smaller institutions and grandfather affiliations prior to March 5, 1987, we still strongly believe that Federal preemption is unnecessary, particularly since no safety or soundness complaints have been raised and since such activity today is de minimis and subject to supervision by both the SEC and the FDIC under operating principles, not dissimilar from those contained in this legislation.

We would be pleased to work with the committee on a solution to this issue that is consistent with the important federalism principles recently enunciated by the President.

These hearings are the committee's first step to fulfill the intent of Congress to conduct a comprehensive review of our banking and financial laws, in light of the changing world marketplace, and we will welcome your commitment.

Mr. Chairman, you, Senator Garn, and numerous members of this committee clearly stated the congressional intent in the Competitive Equality Banking Act, not to extend or renew the moratorium on new banking products and services, which expires next March. This moratorium is designed to bring the various players in the financial services arena to the table to discuss a comprehensive reform of our banking statutes.

The Financial Modernization Act is the right first step for Congress to take as part of its comprehensive review. It is not inconsistent with further reform measures in the future.

By using separately capitalized affiliates of a holding company with the safeguards contained in the bill, we are building upon existing prescriptions for high standards of safety and soundness. I cannot stress enough the importance of having sufficient and separate capital to engage in new activities. It is a theme that I and others in Treasury have stressed in the past and financial leaders around the world have embraced.

Just yesterday, the Wall Street Journal quoted the chairman of Canada's leading securities regulator as saying: "If the last few weeks have taught us anything, it's that adequate capitalization is the No. 1 priority, and the players with the deepest pockets are the banks."

In summary, we support the thoughtful, progressive approach that has been taken by Senator Proxmire and Senator Garn in forging S. 1886. It is timely and carefully crafted to promote competition and, thus, consumer benefits, while assuring that proper regulatory safeguards are in place to protect depositors and the larger public.

I urge all of your colleagues on the Banking Committee to lend their support to our mutual efforts to modernize the Nation's banking laws.

On behalf of Treasury Secretary James Baker and the rest of our team at the Treasury, we stand ready to assist you in any way that we can.

Thank you.

[The complete prepared statement of George D. Gould follows:]

FOR RELEASE ON DELIVERY
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DECEMBER 2, 1987

STATEMENT OF
THE HONORABLE GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ON
THE FINANCIAL MODERNIZATION ACT OF 1987, S. 1886

Mr. Chairman, Senator Garn, and Members of the Committee.

I welcome this opportunity to appear before you in support of S. 1886, the Financial Modernization Act of 1987. There is a still-urgent need to modernize our nation's financial services industry to better serve consumers and business. I also want to commend this Committee for its role in recapitalizing the Federal Savings and Loan Insurance Corporation (FSLIC). That important legislation was made possible by the willingness of the Congress and the Administration to strike a compromise for the good of the public.

It is my hope that this self-same spirit of compromise will set the tone for the important business we now have before us. If so, I am confident that this Committee will agree that S. 1886 provides the proper starting point for broader reform.

Mr. Chairman, the Administration applauds the bipartisan leadership that you and Senator Garn have demonstrated over the years, not only in cosponsoring this pro-competitive and pro-consumer legislation, but also in your repeated public assurances -- upholding the clear statement of Congressional intent in the Competitive Equality Banking Act -- that the moratoria on new products and services will not be extended beyond next March.

As we proceed, Mr. Chairman, we should be skeptical of the defenders of the status quo, who will argue that the recent volatility in the stock market precludes the need to update our antiquated and protectionist financial laws. It does not. Some observers will try to equate the risks involved with investing in the stock market -- a risk we acknowledge up front -- with the alleged riskiness of engaging in new activities by certain classes of financial institutions. They should not. Recent market events, however, have underscored the need for adhering to fundamentals, such as adequately and separately capitalized firms and vigilant supervision to maintain the integrity of the federal safety net. These same real world events should not be used as an excuse or stand in the way of reforming laws to promote both greater competition and consumer benefits.

My testimony today is divided into three parts: a brief overview of the changing world marketplace; the reasons why the Administration supports reform of the Glass-Steagall Act; and then specific comments on the Financial Modernization Act.

Mr. Chairman, you also have asked for our comments on the Financial Services Oversight Act (S. 1891) introduced by your colleagues, Senators Wirth and Graham. While the sponsors obviously have put a great deal of thought and effort into drafting the approach first outlined by New York Federal Reserve Bank President E. Gerald Corrigan, I will be unable to make any specific comments at this time because the Administration does not yet have a formal position on this new legislation. As soon as the Administration reaches a position on the Financial Services Oversight Act, I would be pleased to respond for the record.

The Changing World Marketplace

Like it or not, the financial services world is changing all around us. In the past several years, thousands of pages of Congressional testimony have recorded these changes.

Today's products were not available yesterday; tomorrow's services are not yet contemplated. Technological advances, enhanced access to information, and growing customer sophistication have combined to create a demand for new products and services deliverable on a local, national, and international scale. (For example, the Treasury STRIPS ("Separate Trading of Registered Interest and Principal of Securities") program has reduced the cost to the government of financing the public debt by facilitating competitive private market initiatives with a minimum of direct government involvement.) Near perfect substitutes for traditional banking products found their genesis in powerful economic forces (such as accelerating inflation) and in statutory restrictions dating back to a time few of us really remember. Many U.S. firms fund themselves just as efficiently overseas as they do in this country and even some government-sponsored entities (such as the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Federal Home Loan Bank System) have sold securities in foreign markets.

It was not all that long ago, for example, when the major problem facing all of our depository institutions was that of maintaining a stable source of funds throughout the interest rate cycle. You might remember that it was quite common in the 1970s to have periodic credit crunches brought on by inflationary binges and the "disintermediation" of funds during the high side of the interest rate cycle. Savers simply withdrew their savings from government regulated accounts at depository institutions in favor of new market rate accounts (most notably money market mutual funds) at other financial intermediaries that in large measure were driven by rapidly advancing computer and communication capabilities. After extended and contentious debate, this problem was ultimately resolved in favor of consumers when Congress authorized the phase-out of deposit interest rate controls. Rate decontrol, in conjunction with other innovations (such as money market deposit accounts and interest-bearing transaction accounts) on the liability side of the ledger have given bank managements the flexibility to fund their institutions effectively and efficiently throughout the interest rate cycle.

The public interest has not been served by the strait jacket that in many cases restrains our depository institutions on the asset side from competing head on with other providers of financial services. The most obvious and easily understood example and challenge to traditional commercial banking operations has been the tremendous growth in the commercial paper market as a close substitute for bank commercial and industrial (C&I) loans. Other less regulated financial intermediaries have moved swiftly into the commercial lending field. As the Chairman of the Board of Governors of the Federal Reserve System recently testified, the commercial paper market has more than doubled since 1980, rising from $31 billion to $78 billion as of mid-year 1987. What is even more astounding is the high degree of concentration found in these protected markets. According to Federal Reserve data, about 94 percent of all dealer-placed commercial paper outstanding as of October 1986 had been placed by five large nonbank dealers. Clearly, the public interest would be served by increased competition and safety is enhanced by diversification.

Perhaps the single most important trend today is that of the securitization of a wide range of bank assets. Securitization originated in the 1970s under government auspices as a way to bring new funding to the housing market. Since then, the growth of securitized mortgages has been nothing short of phenomenal. For example, recent Congressional testimony established that as recently as 1980 the volume of mortgage pass- through issuance amounted to about $23 billion; in 1986 that volume had increased by over eleven-fold to about $263 billion. Indeed, over half of all mortgages originated are now securitized in one way or another.

What has taken place in terms of mortgages is even now spreading to other types of assets -- with the potential to increase an institution's liquidity and enhance credit availability for consumers. Automobile loans, consumer loans, credit card receivables, mobile home loans, and commercial loans -- in addition to mortgages -- are now candidates for securitization. If banking organizations are prevented from competing in this emerging area, then their less-regulated competitors will simply move to establish direct funding relationships with the ultimate borrowers, circumventing the banks entirely.

As markets develop and improved risk management is required, both diversification and securitization of traditional bank assets will play an ever increasing role in prudent financial management. Some institutions, particularly smaller banks, may choose to act as originators, servicers, and distributors of new securitized assets, while other, larger institutions may wish to engage in the full securitization process, including packaging and underwriting of these bank portfolio derivatives. Such developments will increase liquidity and should increase the ability to manage the risks of portfolio lending; this trend will encourage safety and soundness over the long run and ought to be encouraged by Congress.

Moreover, states are continuing to respond to local market demands more quickly than the federal government. State initiatives have become an important source of some of the new products and consumer services offered by state-chartered commercial banking organizations. A Federal Deposit Insurance Corporation (FDIC) survey shows that as of April 8, 1987:

-- 11 states authorized direct investment in equities;

-- 13 states authorized underwriting of municipal revenue bonds; and

-- 12 states authorized full service brokerage, and 35 states permitted discount brokerage.

The experience of these states is noteworthy for the lack of problems to date. To the best of our knowledge, not a single incident has been documented where these activities of state-chartered institutions have raised safety and soundness concerns for either the state regulators or the FDIC.

Finally, if editorial opinion is any indication of public sentiment, then most Americans believe that our nation's banks are hamstrung by archaic laws. Dozens of newspapers across the country have called on Congress recently to modernize our financial system and permit our financial institutions to compete. These editorials have not only appeared in the larger cities of New York, Chicago, Detroit, Dallas, Cleveland, Los Angeles, and Washington, but have also surfaced in Oakland, San Antonio, Madison, San Jose, Norfolk, and elsewhere. One Pittsburgh paper, for example, contended that "the Glass-Steagall Act of 1933 is a fossil that is seriously hampering the efficiency of the entire financial services sector -- and, indirectly, the American economy."

Modernization is not an academic discussion lost on the public at large. To the contrary, the public has expressed its vital interest in both new products (as witnessed by the explosive growth of new transaction and savings accounts and creative mortgage instruments) and new providers who offer convenient access to innovative financial services. We simply cannot be satisfied with the status quo or we risk the stagnation of a sector of our economy that not only plays a critical financial intermediation role but also is necessary for our continued economic growth.

A First Step Toward Comprehensive Restructuring

The need to modernize our financial services industry has spawned a large number of reform proposals that are worthy of serious consideration. Some would shift from Congress to the regulators or the states the authority to decide which products and services banks and other financial institutions could provide to consumers. Others focus instead on the structure used by financial services firms to conduct new activities to better serve consumers.

These various reform proposals* -- including both the Financial Modernization Act of 1987 and the Financial Services Oversight Act -- share several common elements, although they differ in structure and the degree of change advocated. All seek to promote greater competition in the delivery of financial services. All seek benefits from this new competition for the end users -- consumers, business, and government. All contain safeguards to prevent unfair competition and conflicts of interest, and all provide for extensive supervisory oversight.

These proposals are timely and thought-provoking. They demonstrate clearly that the Congress has a wide range of alternatives before it. It is interesting to note that many of these proposals rely on the holding company structure proposed by the Administration in 1982 as the primary vehicle for expanding products and services through separately capitalized affiliates.

One of the most striking features in most of these reform proposals is the recommendation that the dated, artificial restrictions between commercial and investment banking ought to be reduced or even eliminated. This common thread is clearly

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FOOTNOTE:

See also, for example: S. 60, "Financial Services Competitive Enhancement Act of 1987," introduced by Senator Garn; H.R. 3209, "Consumer Services Bank Act of 1987," introduced by Representative La Falce; H.R. 3063, "Dual Banking System Enhancement and Financial Services Competitiveness Act," introduced by Representative Carper; and H.R. 3360, "Financial Services Holding Company Act of 1988," introduced by Representative Dreier. Other proposals have been advanced: "Financial Market Structure: A Longer View," by E. Gerald Corrigan, President, Federal Reserve Bank of New York (January 1987); Federal Deposit Insurance Corporation, "Mandate for Change: Restructuring the Banking Industry," (October 1987); and "Modernization of the Financial Services Industry: A Plan for Capital Mobility within a Framework of Safe and Sound Banking," Committee on Government Operations, U.S. House of Representatives (September 1987).

recognized in the Financial Modernization Act of 1987. Amending the Banking Act of 1933 -- the so-called Glass-Steagall Act -- is the proper first legislative step.

We are all aware of the reformation of financial markets around the world, as illustrated by the Big Bang in London last year, and extending to Canada, Japan, and this country as institutions struggle to follow and finance their customers wherever they may operate. The name of the game is customer service. For most American industries, satisfying the consumer has always been the bottom line, but banking organizations have not always been able to keep pace with the financial needs of their customers. As a reaction to the Great Depression, Congress imposed rules that tried to achieve stability at the expense of service. These rules may have been well intentioned -- they even restored financial confidence for a time -- but the Glass-Steagall prescription did nothing to cure the larger economic ills that forced the closing of over 7,000 banks. Rather, it was the creation of federal deposit insurance, the establishment of the Securities and Exchange Commission, and lessons learned by Federal Reserve experience that advanced financial stability. In retrospect all that some of these rules did was protect various segments of the financial industry from competition -- and they offered little incentive to better serve consumers.

As I mentioned earlier, new technology, the inflation of the 1970s, and new competition have changed the marketplace. Too often, our vision of better consumer service ignores such change and gets lost in the thicket of debate on whether or not to preserve one industry's domain over a certain kind of service. Too often, we end up debating the relevance of fifty year old laws for a time gone by, instead of focusing on current and future service to consumers.

I believe we need to change our focus -- toward consumer service and away from interest group protection. Yes, we must always be concerned with safety and soundness. But that concern need not mean that anti-competitive behavior must remain entrenched forever. We must recognize that the 1930s legislative framework is itself unsafe and unstable in the new world marketplace: it sacrifices fair competition -- particularly in products and services -- for the deceptive nostalgia of an era long since gone. The financial institutions that once may have benefitted from 1930s restrictions are now hindered by them -- with potentially dangerous consequences for the future if they are not permitted to keep pace with ever-changing business needs and consumer demands.

Our mutual focus must be on the needs of consumers -- and not on the self-serving pleas of special interests seeking government's help to thwart competition. For the ten reasons I will outline below, the Administration supports modernizing the Banking Act of 1933 to permit the affiliation of commercial and investment banking subject, of course, to the watchful eye of the proper supervisory agencies.

Glass-Steagall Reform

1. Competition is enhanced and concentration is avoided.

The Glass-Steagall Act is essentially protectionist legislation, and in the long run artificial economic barriers do more harm than good. Competition is a prerequisite not only for the advancement of economic well-being in our society but also for safety and soundness in the long run. We urge the Committee to focus on the public benefits to be gained from fair and open competition between commercial and investment banks.

Consider the following data about the degree of concentration in the investment banking industry:

- In 1986 five securities firms managed 69 percent of the dollar total of all underwritten public debt offerings, and five firms managed 95 percent of all public offerings in which the securities firm acted only as agent.

- In 1986 five securities firms managed 47 percent of the dollar total of all underwritten public offerings of common and preferred stock, and five firms managed 26 percent of equity offerings in which the firm acted only as agent.

- In 1986 five securities firms managed 41 percent of the dollar total of all underwritten municipal revenue bonds.

- In the first half of 1987 five securities firms managed 99.9 percent of the dollar total of all underwritten asset-backed securities.

- In 1985 the top five mutual fund complexes in each group managed 60 percent of taxable money market funds, 81 percent of U.S. Government or repo money market funds, 59 percent of tax exempt (non-money market) securities funds, 53 percent of U.S. Government (non-money market) securities funds, 54 percent of corporate equity funds, 46 percent of corporate debt funds, and 60 percent of foreign securities funds.

Similar facts about this highly concentrated industry were recently compiled in an excellent study by the House Government Operations Committee. I urge you to review that Committee's findings for yourselves.

2. Consumers benefit.

Businesses, municipalities, consumers and the economy as a whole would benefit substantially from enhanced competition between the commercial banking and the securities industries. There would be a greater variety of products, more convenience and lower costs. For example, in recent testimony before the Senate Banking Committee, associations of ultimate users, the National Governors Association and the National League of Cities, strongly supported allowing commercial banking organizations to underwrite municipal revenue bonds. The enhanced underwriting competition would decrease the costs of issuance, increase the market for these bonds, and provide significant savings to state and local governments. Indeed, a review by NYU Professor William Silber of 12 studies by nine different research teams concluded that increased competition from banks and bank holding companies would result in savings to state and local governments of between 6.7 and 13.3 basis points. While only a rough calculation, 10 basis points on approximately $108 billion of new issue revenue bonds in 1986 would have saved state and local governments $108 million in interest costs that year. This conclusion is consistent with estimates of a 5 to 10 basis point differential made by the Government Finance Officers Association, according to testimony of the National Governors Association.

Similarly, the National Association of Realtors, the Mortgage Bankers Association, and the National Association of Home Builders strongly supported commercial bank underwriting and dealing in mortgage-backed securities as a means of lowering the cost of housing finance. The trend toward securitization, they have testified, is indispensable to growth in the housing market, which depends on reliable availability of mortgage capital. Moreover, this trend has the additional salutary effect of increasing private sector participation in a market largely dominated by federal agencies.

Consumers of all income levels and types should benefit as well. More investment opportunities should be available to consumers as banking organizations of all sizes offer more -- and hopefully more efficient and beneficial -- products and services. Take discount brokerage, for example. My impression is that consumers have in fact benefitted from having depository institutions in this line of business, recent market events notwithstanding. The ability of banks to organize, sponsor and sell mutual funds is another example of how "ordinary" consumers in every community in this country could benefit by having more investment opportunities available. As we have seen, most mutual funds have fared well and remained stable during recent weeks. Similarly, business consumers stand to gain from lower borrowing costs if banking organizations can underwrite commercial paper more cheaply than by making traditional commercial loans. These are the kinds of new opportunities for consumers that Congress cannot afford to ignore.

Absolute prohibitions ought to be avoided when there are overriding public benefits to be gained and any abuses can be managed adequately by targeted regulation and supervision. Assuming proper disclosure and safeguards against tie-ins and conflicts of interest, Glass-Steagall reform clearly would be pro-consumer and pro-competitive.

3. Risk is diversified.

Reforming the Glass-Steagall Act would enable banking organizations to diversify their earnings, attract new capital, and better meet the needs of their customers. Thus, it would be consistent with good business practice. Underwriting and dealing in securities could substantially reduce risk to the bank for two reasons. First, studies have shown that securities underwriting is no more risky -- and probably less risky -- than commercial lending. Second, studies also have shown that when securities underwriting is combined with commercial lending, overall earnings variability is reduced because of the negative earnings correlation between the two activities. Furthermore, by attracting new capital and enhancing the value of the franchise and by stemming the erosion of assets, banks will be in a stronger position to meet the challenges of the future.

4. Basic safeguards already are in place today.

Numerous structural safeguards -- such as the Federal Deposit Insurance Corporation and the Securities and Exchange Commission -- have been instituted since the problems of the 1930s. Federal oversight of banking organizations has been greatly strengthened to promote safety and soundness. Moreover, many other safeguards to protect against risk, avoid conflict of interest abuses such as tie-ins, and promote fair competition already are in place.

For example, the FDIC requires nonmember banks to conduct securities underwriting activities (authorized by state law) only in bona fide subsidiaries designed to avoid safety and soundness problems and other concerns. Sections 23A and the new 23B of the Federal Reserve Act (Sec. 102 of the Competitive Equality Banking Act of 1987) impose restrictions on transactions and require arms-length transactions between insured depositories and their affiliates to promote fair competition, avoid conflicts of interest, and prevent undue risk. These existing requirements create a system of regulation that makes a complete separation unnecessary in today's modern world. A more complete listing of existing safeguards is attached as Appendix A.

Members should readily agree with us on the need to conduct these new activities in separately and adequately capitalized entities as a prerequisite for properly insulating the bank. We should be frank in recognizing the facts of today's marketplace: margins are often thin, volatility is an everyday occurrence, and capital hits can and should be expected from time to time.

Events of the past few weeks have underscored the need for sufficient capital to withstand market risk, a point I highlighted in a recent article. One of my major points is worth repeating for this Committee:

> "Capital enables firms to offer services at competitive fees and to absorb losses from risks inherent in volatile markets....American companies also need more capital to increase their margin for error -- to make them safer....The Treasury believes that American companies will have to increase their capital bases to compete in world markets."

In the final analysis, adequate capital can and should serve as a protective buffer to the federal safety net, particularly when we require both banks and their securities affiliates to observe separate capital requirements for separate operating entities. Ensuring that sufficient capital exists also achieves two other important objectives: stockholders have their own funds at risk up front and the markets themselves can exert a degree of discipline when an institution needs to raise capital.

One additional deterrent Congress may wish to consider to ensure the proper insulation of an insured institution is to increase the sanctions for violations of the norms for conducting new activities. If penalties were to be increased beyond the $1,000 per day civil money penalty for violating interaffiliate restrictions and the cost were both high enough and certain, then violations would be minimized. As you know there is recent precedent for increasing such sanctions in the area of money laundering; sanctions against interaffiliate transactions ought to be at least commensurate with those which exist for illegally laundering money through financial institutions.

5. Banks already engage in many securities activities.

The exercise of full domestic securities powers by bank affiliates is a logical extension of the existing activities of commercial banks. Banks are major players in underwriting and dealing in U.S. Government securities and municipal general obligation bonds. In recent years banks have been active as discount brokers.

Commercial banks today are permitted to underwrite and distribute obligations of the World Bank for economic development in third world countries, but they are largely precluded from underwriting and dealing in bonds for local economic development efforts in this country. Banks can underwrite the general obligation bonds of states or their political subdivisions, but they cannot underwrite securities backed by a non-tax revenue stream such as tolls or other fees. They can underwrite and deal in the full range of corporate securities abroad, but cannot compete for the long-term capital needs of American companies at home. Finally, banks can underwrite bonds to support public housing and dormitories for our students, but they are precluded from underwriting mortgage-backed securities to help finance housing for middle-income Americans.

All of these existing operations have been profitable segments of bank business and have never been the cause of a bank failure in modern times. The addition of a full range of new securities powers in the domestic product line will fill a service void left vacant largely for protectionist, rather than for real economic or safety and soundness, reasons.

6. Innovation and opportunity would be enhanced.

Reform of the Glass-Steagall Act will allow banking organizations to offer additional financial services and products to businesses that were formerly offered only by securities firms. It will also permit banks to be innovative in providing new products and services based on their understanding of the market.

Conversely, by affiliating with commercial banks, securities firms will be able to create and expand the types of financing they can offer businesses. They too will be able to offer innovations based on their perspective of the market. For businesses, there will be more financial service vendors. This should mean more favorable prices and better, more diverse products and services. The greater number of financial firms and the resulting increase in competition should focus more attention on small and specialty businesses and other niches in the market that received less attention in a less competitive environment. The resulting efficiencies would benefit the corporate and household consumers of financial services, while a less volatile stream of income across the combined entities should contribute to the stability of financial markets. Hence, Glass-Steagall reform should have a positive effect on all types of economic activity, not just on the financial services sector. Both that sector and the economy in general should be stimulated by the new, more competitive market.

7. Glass-Steagall reform is consistent with both safety and soundness and insulating a bank from its affiliates.

This Administration has gone to great lengths not to extend federal guarantees -- and expose taxpayers -- unnecessarily. We see no need to extend the federal safety net further into the financial area. We should permit the affiliation of commercial and investment banks. We have insulated insured banks to protect depositors and taxpayers, and we will continue to do so.

The federal bank regulators unanimously have endorsed reform of the Glass-Steagall Act. They believe that banks through separate entities can undertake a full range of securities activities without any threat to the safety and soundness of the banking system.

Conducting new securities activities in a separately capitalized affiliate would insulate these activities from those of the federally-insured bank. The regulators believe that appropriate barriers between the bank and the securities affiliate can fully insulate the bank from financial problems of an affiliate. Moreover, the regulators want a successful separation of bank and securities affiliates to make Glass-Steagall reform both safe and workable. There should be no reason for securities activities (or any other new business) to impose upon the federal safety net.

8. Financial services conducted safely overseas could now be done in the United States.

Reform of the Glass-Steagall Act would permit banks through separately capitalized affiliates to engage in all types of securities activities. They will finally be able to conduct domestically the broad based securities business they have long conducted overseas. American banks will thus be more competitive with their foreign counterparts who, particularly in Europe, have been able to conduct securities business at home and abroad.

American banks will be able to provide international businesses -- American and foreign -- with a greater range of financial products and services.

A number of European banks have been able to engage in both the securities and banking business in the United States since they arrived here. In 1978 many of the foreign banks had their securities activities grandfathered under the International Banking Act; they have continued those activities without any safety and soundness threats. Now domestic banks will be able to meet this foreign competition at home. Since the United States is the largest banking and securities market in the world, the ability of domestic and foreign banks and securities firms to compete here effectively should be a big boost for better financial services and continued economic growth.

U.S. banking organizations already are involved in a wide range of securities activities in major overseas markets. To restrict these organizations from engaging in comparable securities activities in the domestic markets can only lead to the eventual erosion of the primacy of U.S. capital markets and the consequent decline in employment, income and other economic benefits that accrue to the United States therefrom. Glass-Steagall reform would make such a migration of business or employment opportunities unnecessary.

9. Greater securitization is facilitated.

A major trend in financial markets currently is that of securitization of assets, a phenomenon driven by the advent of modern computer technology, telecommunications, and consumer sophistication. The initial securitization of mortgages has now been joined by the securitization of auto loans, personal loans, credit card receivables, mobile home paper, commercial paper, and others. The ability to securitize assets and distribute those securities in the financial marketplace permits direct funding by the ultimate creditors, largely circumventing the traditional funds intermediation and loan warehousing role of banks.

Glass-Steagall reform would allow banks to capitalize on their existing expertise to compete in all aspects of securitization, thereby offsetting any decline in profits attributable to diminishing loan volumes.

10. Competitive equity is promoted.

The failure to modernize Glass-Steagall could seriously undermine the principle of competitive equity between different classes of banking organizations. Just recently, the Supreme

Court upheld the right of states to authorize the full range of securities activities for state-chartered nonmember banks. Unless Glass-Steagall is overhauled, member banks will continue to be prohibited from engaging in significant securities activities, leaving them competitively disadvantaged. A situation of this type can also be expected to result in some erosion of membership in the Federal Reserve System as some state-chartered member banks leave the System, and some national banks switch to state-chartered nonmember status, to take advantage of securities activities. This situation can be avoided by amending Glass-Steagall and providing for competitive equity.

As the Committee continues its debate and advances legislation, I respectfully want to suggest a number of guiding principles that ought to serve as the foundation for your deliberations.

- First and foremost, insured depositors ought to be protected: we need to preserve the option for safe savings instruments for small savers.

- Second, the federal safety net should not be extended beyond insured depository institutions; securities affiliates ought to be viewed legally, publicly, and financially as separate units for safety and soundness reasons.

- Third, the functional regulation that characterizes our financial system should be preserved and expanded; thus, depository institutions will be regulated by federal and state banking agencies while securities affiliates will be regulated by the SEC and state securities administrators.

- Finally, the historic right of states to authorize activities for their state-chartered institutions is another principle worth maintaining and should not be pre-empted lightly to enforce a single national rule; certain national prescriptions may be appropriate for the conduct of new activities but we should acknowledge the real benefits such as product innovation and the provision of greater consumer service that flow from our dual banking system.

The Financial Modernization Act of 1987

The Administration applauds your yeoman efforts, Mr. Chairman, to work with us, Senator Garn and the federal bank regulators to craft legislation that truly serves the public interest. The Financial Modernization Act is worthy of strong bipartisan support and is the appropriate first step for Congress to take. Not only is it pro-competitive and pro-consumer, as I indicated at the outset, but it also adheres to high standards of safety and soundness which both the Administration and Congress share.

The fundamental structure of the Financial Modernization Act can be traced to the Administration's first proposal to modernize our banking laws through a holding company format and to the legislation which Senator Garn, with your support, spearheaded through the Senate in 1984. Many of the safeguards we suggested then and now have been incorporated and, in some important instances, enhanced in this legislation.

Title I amends Sections 20 and 32 of the Glass-Steagall Act to permit the affiliation of commercial and investment banking in a holding company structure. Commercial banking organizations would be allowed to have a securities affiliate and a holding company that is 80 percent in the securities business would be able to acquire a commercial bank. As the Committee knows, many securities firms today are affiliated with banks and are grandfathered under both CEBA and this legislation. New securities affiliates are required to be separately capitalized and that capital would not be counted as part of the bank's required capital. This provision should go a long way toward alleviating concerns about increased risk from engaging in new activities, assuming of course that capital requirements established by the regulators are sufficient. Entry into new securities activities would be monitored closely by the regulators, with both the SEC and the Board of Governors playing a major role to assure that firms have the requisite managerial talent and necessary financial strength.

Title I also prohibits the merger of the 15 largest bank holding companies with the 15 largest securities firms as measured by asset size. Existing laws (such as the anti-trust statutes and the Federal Reserve's authority under the Bank Holding Company Act), the degree of competition today, and existing market structure make this provision largely unnecessary and would create an undesirable and arbitrary precedent.

Numerous consumer and safety and soundness safeguards are contained in S. 1886 as well to assure a financial marketplace that is both efficient and safe. Because of these safeguards, the federal safety net should in no way be jeopardized and, because of the holding company format and the use of separately capitalized affiliates, clearly is not expanded. The testimony you will receive from the federal bank regulators will concur in this judgment.

Full and proper disclosure is an important safeguard in the bill. Securities affiliates, for example, must disclose to consumers that their obligations are in no way backed by their affiliate bank or insured by the FDIC, a major part of the federal safety net I have mentioned. Similarly, a bank cannot express an opinion on securities being sold by its securities affiliate without disclosing that its affiliate is selling that security. In short, proper disclosure is a key element in consumer protection in this area.

Lending between a bank and its securities affiliates is also prohibited as a general rule, with an exception for fully securod intra-day loans for the purpose of clearing government securities. While many observers can argue that the existing safeguards contained in Sections 23A and B of the Federal Reserve Act are sufficient to control lending between a bank and a securities affiliate, it can be argued that the requirements of the bill would reduce risk and prevent conflicts of interest in the credit granting role that banks perform.

Moreover, the securities affiliate cannot sell securities to the bank or its trust accounts during the underwriting period or for 30 days thereafter. Similarly, the securities affiliate cannot otherwise sell securities to the bank or its trust accounts unless the sale is at an established market price. Thus, there are additional checks on any potential conflicts of interest, real or otherwise.

One area where we do have reservations is in the area of federalism and states' rights. Sec. 107 in effect removes the exemption from the Glass-Steagall Act for subsidiaries of free-standing state-chartered, nonmember banks, an exemption recently affirmed by the Supreme Court. While other provisions in the bill are designed to ease the formation of holding companies by smaller institutions and grandfather affiliations prior to March 5, 1987, we still strongly believe that a federal preemption is unnecessary, particularly since no safety or soundness complaints have been raised and since such activity today is de minimis and subject to supervision by both the SEC and the FDIC under operating principles not dissimilar from those contained in the legislation. We would be pleased to work with the Committee on a solution to this issue that is consistent with the important federalism principles enunciated by the President when he issued Executive Order 12612 on October 26, 1987.

In summary, Mr. Chairman, we support the thoughtful, progressive approach that you and Senator Garn have forged in S. 1886. It is timely and carefully crafted to promote competition -- and thus consumer benefits -- while assuring that proper regulatory safeguards are in place to protect individual depositors and the public at large. I urge all of your colleagues on the Committee to lend their support to our mutual efforts to modernize the nation's banking laws.

Conclusion

These hearings are the Committee's first step to fulfill the intent of Congress (as contained in Sec. 203 of the Competitive Equality Banking Act of 1987, Public Law 100-86) to conduct a comprehensive review of our banking and financial laws in light of the changing world marketplace. The Administration applauds the Committee's efforts.

Congress also clearly stated its intent in the Competitive Equality Banking Act not to extend or renew the moratorium on new banking products and services which expires next March. Your assurances, Mr. Chairman, and those of Senator Garn, the seven signers who joined you in signing the additional views in the Senate Banking Committee Report that accompanied CEBA, and the statements of others are encouraging and certainly appreciated by the Administration. This moratorium was designed to bring the various players in the financial services arena to the table to discuss a comprehensive reform of our banking statutes. Although we did not see the necessity for such a moratorium, we genuinely welcome the dialogue that it has fostered.

Ever since this Administration came into office, we have urged Congress to conduct a major overhaul of our financial laws by breaking down outdated, protectionist provisions to better serve consumers and business alike. As President Reagan indicated in August, his willingness to sign the FSLIC recapitalization legislation was based in part on Congress' statement not to renew the moratorium, whether or not subsequent legislation is passed by Congress. An extension of the moratorium would fly in the face of needed reform and prohibit our financial institutions from becoming more competitive.

In closing, we have said before that it is time for a change. The United States needs to modernize its banking laws and to reassert itself at the leading edge of the financial services world. We have the talent, the ability, and the motivation to do it. We certainly have compelling reason to do it to have our financial institutions be competitive, both here at home and overseas.

If our nation's financial institutions cannot evolve to meet consumer demand and global competition, then the term "counting house" industry may become an epitaph like "smoke stack" or "rust bowl." This trend is still hard for many to accept, but it is real nonetheless. If Congress applies the protectionist model by trying to repair the crumbling walls of financial oligopolies, the marketplace, technology and consumer tastes will move beyond -- and abroad. The victim will be one more U.S. industry that would not -- or in this case -- could not evolve to meet today's global competition.

On behalf of Treasury Secretary James Baker and our team at Treasury, we stand ready to assist you in any way that we can in your endeavor to modernize our nation's financial system and better serve consumers in this country.

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Aggregate Capital Position of
Eleven Major Securities Broker-Dealers
at the End of September and October 1987

		Capital ('000 dollars)		
Firms	Net Worth	Capital Infusion	Net Capital	Exce Ca
11 Major Broker-Dealers				
September, 1987	21,957		7,463	6
October, 1987	22,898	1,280	8,373	7

"Capital computations are based on federal statutes and SEC rules for the securities industry."

Existing Safeguards for Regulating Bank Transactions with Affiliates

Existing Safeguards

1. Affiliate Transactions Already Restricted

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) restricts transactions between federally-insured banks and their affiliates. (Section 23A does not extend to direct nonbank subsidiaries of banks, however, unless the Federal Reserve Board determines on a case-by-case basis that such subsidiaries should be covered by the restrictions of Section 23A.) It provides that "covered transactions" with a single affiliate must be restricted to no more than 10 percent of the bank's capital and surplus, and with all affiliates to no more than 20 percent. Covered transactions include:

-- loans or extensions of credit to an affiliate;

-- the purchase of or investment in securities issued by an affiliate;

-- the purchase of assets from an affiliate (unless specifically exempted by the Federal Reserve Board);

-- the acceptance of securities issued by an affiliate as collateral for a loan to any person or company; and

-- the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

All covered transactions must be on terms consistent with safe and sound banking principles and are supervised by the banking agencies. Additionally, all loans, guarantees, acceptances, and letters of credit on behalf of an affiliate must be collateralized between 100 and 130 percent.

2. Arm's Length Transactions Required

A. Restrictions on Transactions with Affiliates

New Section 23B of the Federal Reserve Act (Section 102(a) of the Competitive Equality Banking Act, P.L. 100-86) imposes additional conditions on transactions between federally-insured banks and some of their affiliates. Specifically, an insured bank may engage in certain transactions with an affiliate only if

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Source: U.S. Treasury Department, Office of Financial Institutions Policy, October 30, 1987

The **Chairman**. Thank you, Mr. Secretary.

JAPAN HAS ITS OWN BRAND OF GLASS-STEAGALL

Mr. Secretary, as you know, Japan presently has its own Glass-Steagall type law, separating commercial banking and investment banking. One argument for the repeal of Glass-Steagall is that it would make U.S. banks stronger and more competitive in their international competition with foreign banks.

Are you aware of any movement in Japan to repeal its own Glass-Steagall law to make its banks more competitive, internationally, and if Japan acted and we did not, would that further handicap our banks in their ability to compete internationally?

Mr. **Gould**. Well, actually, Mr. Chairman, I have, within the past month or two, met with several members of the Japanese Diet and representatives of the Finance Ministry in Japan to discuss that very topic. I think the Japanese view is that they have Glass-Steagall, because, in the beginning of the post-War period, we were instrumental in setting up many of their institutional regulations and laws and that they sort of inherited the Glass-Steagall from us and didn't necessarily design it on their own.

There are various committees of legislators and private sector people who have been studying this issue for several years.

I think there is a trend very much in the direction that there is a trend in this Congress to try to modernize or amend Glass-Steagall; however, I think their universal comments have also been that they are watching events here, and at least in that respect, view us as the leader in such reform.

So I think if the progress through the Congress that I hope to see for your bill takes place, then I think it would spur similar actions in Japan.

The second part of your question, however——

The **Chairman**. Let me ask you on that point. Are you saying that if we do not act, Japan probably will not act?

Mr. **Gould**. I'm not sure I'm qualified to go that far. No one has said it to me in those precise terms; rather, I think the opposite, that action here would spur action there. But if there were to be unilateral action on the part of the Japanese, I think it would accrue to the benefit of the Japanese banks, as opposed to the American banks, and I think it would hurt the competitive position of the American banks.

The **Chairman**. You voice concern on page 17 or your testimony that section 107 of S. 1886 moves the exemptions from the Glass-Steagall Act from subsidiaries to freestanding State-chartered nonmember banks.

You say that since the securities activities of these banks are de minimis, they need not be brought under the safeguard of the Financial Security Act set forth in S. 1886.

Isn't it true that securities activities of these banks are de minimis because, for most of the 54 years since the passage of Glass-Steagall, there was no perceived exemption for such State-chartered, nonmember banks? And isn't it true that the so-called "exemption" of these banks came from a regulatory decision by the

FDIC in 1983, and section 107, therefore, does not take away from such banks, a long-held and fully established right?

Mr. GOULD. I think it is probably true to say, it's not a long-held or perhaps, in a congressional sense, fully established right; however, we feel within the administration that the dual banking system has created benefits. There has been innovation in a number of financial services which have been the product of local or regional determinations, and that we would like to continue to see that innovation take place, providing, as always, that it doesn't constitute a safety and soundness hazard.

We don't see that hazard in this instance. And even though it may not have as clear congressional origins as perhaps we would all like, we do not see it as an abuse that needs to be preempted by Federal statute.

OVERSEAS SECURITIES ACTIVITIES OF U.S. BANKS

The CHAIRMAN. Mr. Gould, you pointed out on page 14 of your testimony that U.S. banking organizations are already involved in a wide range of securities activities in major overseas markets. I understand this includes underwriting and dealing in corporate data and equities.

Do you think the committee should amend S. 1886 to make it applicable to the overseas securities activities of U.S. banks? Why or why not?

Mr. GOULD. I think I feel very much the way I understand Chairman Greenspan expressed himself on that subject.

We do not see again abuses abroad or safety and soundness concerns for American banks by the way they are currently structured. I think to require substantial change in the way they're doing business now is merely to provide another impediment to our international competitiveness. I think Chairman Greenspan used the old phrase: "If it's not broke, don't fix it." And I think that would be our attitude toward this. It is conforming to the necessities of competition abroad, and we don't see a safety and soundness necessity to incorporate those offshore businesses in the structure that you propose for domestic activities, even though we strongly support the structures that you have espoused domestically.

That is somewhat asymmetrical, but I think that is less important than the fact that they are organized abroad with an eye to how do they compete with foreign institutions. They seem to have done that rather successfully.

The CHAIRMAN. Isn't the underwriting exploding in volume? Isn't there an enormous increase in recent years in investment abroad and underwriting abroad and international competition, and so forth?

John Heimann testified before the committee and opened my eyes to the terrific increase in trading.

I would assume there's probably a parallel increase in underwriting, and that while there has been—you're absolutely right, there's been no problem now that suggests we have to fix something, nevertheless, it would seem to me that if the volume increases, if there would be a series of difficulties, recessions in foreign countries, whatever, that we might have a problem.

Mr. GOULD. I think it is certainly an area this committee should continue to monitor. Indeed, I think with the results of the last month or so I think there may be further insights that could be gained from such monitoring because foreign markets have been as volatile or more volatile than our own. I think they provide a real life example of whether there are inherent weaknesses in the structures as they now exist.

It is true that both the volume of trading is up and for long periods the volume of underwriting is up, particularly in the Eurodollar market. Whether that trend should be continuously extrapolated up, I personally doubt.

So I think they have adapted themselves very well, but I think it is something that should continue to be looked at.

The CHAIRMAN. You pointed out on page 12 of your testimony the fact that there are already major players in underwriting dealing in U.S. Government securities, municipal and general obligation bonds, and discount brokerage activities.

On page 15 of your testimony, you say your support for functional regulation; that is, bank regulators should regulate depository institutions and the SEC securities activities.

Consistent with that approach, do you think that banks committed to exercise new securities powers in a separate affiliate should be required to move their existing securities powers to that new affiliate?

Mr. GOULD. No, sir, I don't think that is necessary based on the record of safety and soundness that has been well-established by dealings in traditional activities, such as Government security trading and full faith and credit municipal trading.

The CHAIRMAN. I might interrupt. It might help you in your answer to be aware of the fact that Chairman Ruder of the SEC has indicated that this is crucial to his position on the bill, that under present circumstances, the bill as presently drafted, he would feel it necessary for the SEC to oppose the bill, and if we are going to have him aboard, we might have to make a compromise.

Mr. GOULD. Well, I cannot tell you, Mr. Chairman, that I have really had a chance to read fully his comments, although this morning before coming here I read the executive summary of his testimony, and he did seem to indicate in that that he feels the province of the SEC should extend to activities in a bank in the same manner they would extend to securities firms.

My feeling that that is not necessary is again to use a real life case example. I do not see abuses that have occurred by those activities conducted in banks. I am aware of the statement that a bank in Minneapolis lost substantially on its Government portfolio and here and there there have been other isolated examples.

But I think those were a function of bad investment judgments, not problems that would have been eliminated or obviated by the fact that the SEC had oversight as opposed to the bank regulators.

My impression—and again I only glanced at it—my impression of Mr. Ruder's comments were that he was concerned with protecting the public in a number of these instances, and while that is an important concern if we are talking about Government securities in particular, I would like to think that there is no credit risk in those securities and that some of the safeguards normally associated with the SEC dealing with regulation are not applicable in this instance.

Having said all that, I would be happy on behalf of the Treasury to work with Chairman Ruder, and I am sure the bank regulators would be, too, to see what middle ground there might be in this position.

The CHAIRMAN. We appreciate that very much. I think that would be very constructive because I have great respect for Chairman Ruder and also, of course, for the SEC, which has a very fine staff and has done a superb job over the years in, as you say, protecting the public interest.

FEDERAL RESERVE BOARD RECOMMENDATION

Mr. Gould, Mr. Greenspan told our committee yesterday that the Federal Reserve Board recommends that the Banking Committee focus its attention on the Glass-Steagall Act and not on more generally comprehensive proposals that have been introduced. He said the Board favored S. 1886's incremental approach to granting new powers.

Do you agree with the Federal Reserve's recommendation in that regard and, if so, why?

Mr. GOULD. I do, although as recently as last evening Senator D'Amato and I had a conversation with respect to his bill. He pointed out to me—and again I have only had a chance to glance at all 150 pages of it last evening—but he felt that the time was ripe to deal with a more comprehensive restructuring for many of the reasons that we have advanced and I think that you have advanced, in the sense that there is a need to modernize the structure to conform with marketplace reality.

But the reason at this point in time that the administration supports your bill is that it goes, in our view, a substantial distance toward modernization and does it in a fashion that does not preempt either Senator D'Amato's bill or Senator Wirth's bill from consideration and, indeed, for implementation at a further date. There is nothing contradictory between S. 1886 and further reform in the future, if Congress so desires.

My personal observation and the experience in the last few years are such that if I were to make a political judgment I would say that trying to do something more comprehensive might simply bog down what modernization is already inherent in your bill.

Now, that is a judgment others may be able to make better than I, but I think that as long as S. 1886 does not preempt by its structure the essence of the other two bills we at this time would support this as an important first step and not feel it was practical to go further at this time.

The CHAIRMAN. Now, in your testimony you object to provisions of the Proxmire-Garn bill restricting mergers between large banks and securities firms. Such a provision would also apply to large foreign firms seeking to develop a presence in the U.S. market.

First, would it be a matter of concern to you if foreign firms acquired a large presence in the U.S. market?

Mr. GOULD. Not, if I may say, in sort of a philosophical sense. We have pressed, not with notable success, but we are still pressing other countries to open their markets in terms of financial services as well as in other ways. It is sort of, if you will, the American spirit for openness and free competition, although we would like to see national treatment, certainly, of American firms in other countries, and within that spirit of competition that can be proconsumer and probusiness. To exclude foreigners who would offer services here is really rather contrary to the thrust of free market opportunity.

There almost seems to be creeping into these sorts of discussions what I perceive as fear that Americans are no longer able to compete. I feel that is an unwarranted fear. I feel that in the securities industry we should welcome properly structured competition, and I am not yet willing to throw in the sponge and say that American firms are not able to compete with firms that come in, whether they are European firms or Japanese firms, always subject to concerns about undue concentration of economic power and for safety and soundness.

So as far as we are concerned as an administration, we would not find the entrance of more foreign firms to be something that should be forbidden by law.

COMPETITIVENESS AND BANK SIZE

The CHAIRMAN. You and I may disagree on this, but I have the strong feeling that size is not the principal element in the competitiveness of banks and that while Japanese banks are far bigger than our banks and some other countries have larger banks than we have, that our banks have been, as Chairman Volcker put it, at the cutting edge in international competition. Indeed, even in Japan the most competitive international bank is the Bank of Tokyo, which is about 29th in size worldwide. It is not one of their very big banks.

Do you feel that our banks are large enough so that they can compete effectively?

Mr. GOULD. Well, I have tried to focus on the role of capital when it comes to size. I think asset size is by no means a good measure. You can have very large assets that are largely composed of secondary or tertiary credits and the return on those or the risk/reward ratio could be quite poor. So merely adding up the assets and saying that that denotes competitiveness or that that denotes success I think is the wrong way to measure it.

My own upbringing in business was that a major measure of competitiveness, a major measure of good management and efficiency was return on equity or return on capital. That remains, in my mind, as the way to judge competitiveness.

We have seen instances in the past month or so in financial markets, in particular, where the amount of capital in the American financial system has been a very key aspect of having that system survive a severe shock with minimum disruption, something that pleased me very much and that I think speaks to the necessity for banking institutions to have adequate capital to compete abroad with whatever mechanisms of competition are taking place.

The indications to us are that capital has become an increasingly competitive tool. So it is adequate capital or the amount of capital rather than size of assets which is uppermost in my mind.

Parenthetically, I would have to say that the ability to retain earnings and build capital or, indeed, the ability to attract capital from outside sources is going to be a function of what those banks are allowed to do in terms of the nature of their business. They are not going to attract capital or retain capital if they are compelled to remain behind the walls of Glass-Steagall and deal with a shrinking market.

So modernization of structure to me is a necessary prerequisite of our firms having adequate capital to compete. Size alone is not something I would endorse, but the need of capital and proper returns on capital I would endorse.

The **CHAIRMAN**. That is very helpful, Mr. Gould. I think your answer clarifies a problem I had with your position. I think I misunderstood it. That is a very useful clarification.

Before I yield to Senator Garn, I have one other question relating to your objection to the provisions of our bill that restricting mergers between large banks and securities firms. The question is this. Large banks can still acquire small securities firms and vice versa.

Wouldn't forcing firms to either buy small firms and build them up or establish a firm de novo be preferable on the grounds of enhanced competition?

Mr. **GOULD**. Well, certainly, an expansion of those people dealing in the underwriting field, as that is an example, is an important aspect of competition, and much of that would come from de novo building of an organization or, indeed, from buying smaller firms and enhancing the competitiveness of those firms by the additional capital that could be brought to bear by acquisition by a bank holding company.

On that basis I think there is an aspect of greater competition that comes from de novo building or acquisition of small firms. On the other hand, I think the concern of the administration on the restrictions of the 15 billion and 30 billion designations of organizations that could merge was that there are already in place through antitrust laws adequate safeguards against concentrations of economic power and that it would be unnecessary to have to put into statute rather arbitrary restrictions as to the size of those organizations that could or could not merge.

Nevertheless, I would agree with the observation that de novo building of organizations for competition with existing organizations is a spur to competitiveness.

The **CHAIRMAN**. Senator Garn.

Senator **GARN**. Thank you, Mr. Chairman.

PREEMPTING STATE LAW

As you know, Secretary Gould, the Proxmire-Garn bill permits one company to engage in both securities and banking, but only by preempting State law and only by establishing a separate affiliate of a holding company regulated by the Federal Reserve Board. I agreed to this because securities activities have traditionally been regulated primarily by the Federal Government. But yesterday the Board suggested that this might be a good precedent for other activities such as insurance and real estate.

I personally do not agree with preempting State law as a general matter. But securities activities are different because they have typically been regulated at the Federal level. I guess that is how I can rationalize departing from my normal opposition to preempting State law. I certainly don't think we should extend such a policy, as the Board indicated might be a good precedent yesterday, to preempting State law for insurance and real estate activities.

What is your feeling on that?

Mr. GOULD. I would agree with you very strongly, Senator Garn. We have a recent Executive order by the President which strongly embraces or endorses federalism in many of its aspects, and preemption here we would find neither necessary nor desirable.

Senator GARN. Again looking at other nonbanking activities, do you believe that other nonbanking activities other than securities must be carried on in affiliates rather than subsidiaries?

Mr. GOULD. Well, I have been exposed to long and interesting conversations with both Chairman Seidman and Comptroller Clarke, who have done a great deal of work on how the safety and soundness concern we all have could be embodied in subsidiaries of banks rather than putting such activities in holding companies. I think they were concerned that smaller banks would have to go through unnecessary creation of new structure and that merely for the concern of safety and soundness putting things in the holding company was not necessarily an additional increment to such safety and soundness.

Indeed, we have had that discussion and Chairman Greenspan has had that discussion. I think there is merit to those arguments.

On the other hand, I think that in the interest of having progress on the services banks can offer on the amendment of Glass-Steagall, I don't think as far as the Treasury is concerned that we would want to have arguments over structure interfere with the basic thrust of the bill and, indeed, there is a historical position of the Treasury for doing new securities activities in the holding company that go back 5, 6, 7 years.

So I think there are arguments that Congress might wish to listen to, but as far as we are concerned, we are prepared to endorse affiliates of holding companies as opposed to subsidiaries of the banks for securities activities.

Senator GARN. I am well aware of the historical precedent. I have sat in Don Regan's office and argued that point at great length 5 or 6 years ago. So I would be surprised if Treasury had changed their mind.

Mr. GOULD. We don't want to appear too inflexible.

Senator GARN. Our bill also creates a special exemption from certain bank holding company regulations for certain pure securities firms that buy banks. This was a concern of mine because I have always wanted a level playing field or two-way street, whatever you want to call it. It seems to me that in changing Glass-Steagall, that securities firms should be allowed to buy banks.

The problem with this special exemption, however, is that in my opinion it doesn't really go far enough. There are firms that are the terms and conditions of the transaction, including credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions with unaffiliated companies (i.e., arm's-length transactions). Transactions covered by Section 23B include:

-- any loan or extension of credit to an affiliate;

-- investments in securities issued by an affiliate;

-- purchases of assets of an affiliate (including agreements to repurchase);

-- acceptance of securities issued by an affiliate as collateral for a loan to any person or company;

-- issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate;

-- sales of securities or assets to an affiliate (including assets subject to an agreement to repurchase);

-- payment of money, or the furnishing of services to an affiliate under contract, lease, or other circumstances;

-- any transaction in which an affiliate acts as an agent or broker, or receives a fee for its services to the bank or any other person; and

-- any transaction or series of transactions with a third party, if an affiliate has a financial interest in the third party, or if an affiliate is a participant in such transaction.

B. Banks Not Responsible for Obligations of Affiliates

New Section 23B also prohibits a bank, or any subsidiary or affiliate, from agreeing, or indicating in any way, that the bank is responsible for the obligations of its affiliates.

C. Banks' Fiduciary Responsibility Protected

Section 23B also prohibits a bank from purchasing as fiduciary any securities or other assets from any affiliate (unless specifically permitted by court order or appropriate law). In addition, a bank, while acting as a principal or fiduciary, is prohibited from knowingly purchasing or acquiring (during the existence of any underwriting or selling syndicate) any obligation for which an affiliate of the bank is a principal underwriter, unless approved by a majority of the outside directors prior to the time at which it is initially offered for sale to the public.

3. Reports Currently Required on Bank Transactions with Affiliates

National banks are required to file with the Office of the Comptroller of the Currency (OCC) four times a year reports that disclose fully the relations between a bank and its affiliates (12 U.S.C. 161). Such reports must be verified by the oath or affirmation of each affiliate's president or other designated officer. State member banks are required to file identical reports with the Federal Reserve Board, except that they file such reports three times a year (12 U.S.C. 334). Any national or state member bank that fails to furnish the required reports on its affiliates is subject to a penalty of $100 for each day the violation continues.

4. Limitations on Loans to Individual Borrowers

The extension of credit by national banks to any one borrower is limited by the National Bank Act (12 U.S.C. 84) to no more than 15 percent of unimpaired capital and surplus. Loans secured by readily marketable collateral are permitted up to an additional 10 percent.

5. Loans to Officers, Directors, and Shareholders

The extension of credit by an insured bank to officials of that bank or officials of its affiliates is restricted by the Federal Reserve Act (12 U.S.C. 375(a) and (b)). Specifically, bank loans to the executive officers, directors, principal shareholders and related interests of insured banks and their affiliates: (i) must not be preferential or present abnormal risk of repayment; (ii) must be approved by a disinterested majority of the bank's board; and (iii) generally cannot exceed the 12 U.S.C. 84 loan limit.

6. Limitations on the Purchase of Securities from Directors

The Federal Reserve Act (12 U.S.C. 375) prohibits a member bank from purchasing securities or other property from any bank director unless such purchase is done on an arm's length basis in the regular course of business, or unless a majority of the board of directors of the bank approves such purchase. In a similar manner, a member bank cannot sell securities or other property to any bank director unless such transaction is done on an arm's length basis and in the regular course of business.

7. Restrictions on Dividends

National banks and state member banks must receive regulatory approval before paying, in any calendar year, dividends exceeding the total of that year's net profits combined with the retained net profits of the preceding two years (12 U.S.C. 60). Additionally, no dividends at all may be paid if losses equal or exceed undivided profits, after deducting losses and bad debts (12 U.S.C. 56).

8. Enforcement Remedies

Existing Civil Money Penalties for Violations

Violations of 23A, 23B and other restrictions on transactions are generally punishable by civil money penalties not exceeding $1,000 per day for each day during which violation continues, and may be assessed against any bank, officer, employee or agent responsible for the violation (12 U.S.C. 1972, 12 U.S.C. 93, 12 U.S.C. 504, 12 U.S.C. 1828).

Existing Cease and Desist Authority

The Federal Reserve Board has existing cease and desist authority (12 U.S.C. 1844(e)) to block unsafe and unsound transactions among units of a holding company. The other bank regulators have similar cease and desist authority to block unsafe and unsound transactions by banks under their supervision (12 U.S.C. 1818). This authority allows the regulatory agencies to institute cease-and-desist proceedings against any bank or bank holding company (or its directors, officers, employees, or agents) engaging in unsafe and unsound practices or otherwise violating banking law.

9. Anti-tying Restrictions in Place

The anti-tying provisions of Section 106 of the Bank Holding Company Act (12 U.S.C. 1972) currently prohibit banks from providing services or extending credit to customers subject to the condition that customers obtain additional services from a bank, or its holding company, or affiliates. These restrictions also prohibit a bank from providing a loan or service on the condition that a customer not seek services from a competitor of the bank. Injured persons can sue for and obtain injunctive relief and treble damages in connection with violations of the anti-tying prohibition.

10. FDIC's Bona Fide Subsidiary Protections

The bona fide subsidiary provisions of the Federal Deposit Insurance Corporation (FDIC) (12 C.F.R. 337.4) currently permit state chartered nonmember banks to engage in a full range of securities activities via a bank subsidiary or affiliate, provided the activities are authorized under state law. The conditions to be met for the establishment of a "bona fide" subsidiary include the following:

-- adequate capitalization;

-- separation of accounting and other corporate records;

-- observance of separate formalities such as holding of separate board of directors' meetings;

-- no sharing of common officers with the bank;

-- maintenance of separate employees who are compensated by the subsidiary;

-- having a majority of directors that are neither officers nor directors of the bank; and

-- conducting business pursuant to policies and procedures independent from the bank so as to assure customers that the bank and the subsidiary are separate organizations (including clear disclosure that the obligations of the subsidiary are not obligations of the bank).

There is no restriction on the types of securities that can be underwritten if: (1) the securities business, whether de novo or by acquisition, has been in continuous operation for five years; (2) it is in good standing with the National Association of Securities Dealers (NASD); (3) its insiders have not been convicted within five years of securities-related crimes or subject to injunction or Securities and Exchange Commission (SEC) order; and (4) each of its supervisors has five years of experience. Otherwise, underwriting is limited to investment quality debt and equity, shares of mutual funds that invest exclusively in investment quality debt and equity, and shares of money market mutual funds.

Other safeguards for the establishment and operation of a bona fide subsidiary include:

-- the requirement that the FDIC be given sixty days notice of intent to establish or acquire a securities subsidiary;

-- restrictions on the extension of credit to a securities subsidiary or affiliate (Section 23A) or to companies the securities of which are to be underwritten by the subsidiary;

-- prohibiting a bank from purchasing any security currently being underwritten by a subsidiary or affiliate unless expressly authorized by trust agreement, court order, or local law; and

-- prohibiting the parent bank from counting its investment in the sudsidiary as a part of the bank's capital.

11. Existing Application Requirements Under the Bank Holding Company Act (BHCA)

The application process (in conjunction with subsequent examination, supervision and regulation) constitutes another means by which banks in a holding company are insulated from the nonbank activities of affiliates. In particular, the Federal Reserve, which regulates all nonbank subsidiaries of bank holding companies, is required to:

-- review and approve each and every application to perform a nonbanking activity other than those specifically authorized by statute;

-- examine the bank holding company and the subsidiary performing the nonbank activity;

-- terminate the holding company's permission to engage in any activity that is judged to threaten the safety, soundness, or stability of the holding company's bank or banks; and

-- enforce the restrictions of Sections 23A and 23B.

Applications to engage in a nonbanking activity are subject to the prior approval of the Federal Reserve under Section 4(c)(8) of the BHCA. The approval process requires that:

-- the applicant apply to the Federal Reserve, and publish notice in a local newspaper, of the proposed activity; and

-- notice of the application be published in the *Federal Register* for public comments with an opportunity for a hearing should a protest be registered.

12. Application Requirements for Bank Activities

Typically, the regulatory agencies require prior notice and opportunity to disapprove those activities to be conducted in bank subsidiaries and can examine the entity performing the activity as well as terminate any activity deemed to endanger the safetv and soundness of the bank.

13. Federal Securities Disclosure and Anti-Fraud Requirements

The federal securities laws variously require SEC registration of publicly-offered securities, periodic reporting by public issuers, and registration of securities industry professionals (including broker-dealers and investment advisers), and compliance with net capital, customer protection, and other regulations. These laws (and implementing SEC regulations) prohibit manipulative and deceptive acts and practices by any person in connection with securities transactions.

Banks are exempted from many of the federal securities registration and regulatory requirements, but publicly owned banks are subject to disclosure requirements. However, bank holding companies, affiliates and subsidiaries generally are not exempt from federal securities law requirements. All banks and their affiliates are subject to the anti-fraud provisions of the federal securities laws.

14. Capital Adequacy

The federal bank regulators currently have the authority to establish through administrative action the minimum capital required of banking institutions (currently 6 percent of assets). Capital requirements can be changed on a case-by-case basis or for an entire class of banks as determined by the regulators. The International Lending Supervision Act (12 U.S.C. 3907) authorizes the banking agencies to direct particular institutions to increase capital.

15. General Rulemaking Authority

In addition to the above safeguards, the banking agencies have general rulemaking authority (e.g., 12 U.S.C. 93a) which is used to provide appropriate safeguards for banks and depositors. The banking regulators can use these existing statutory authorities for extra protections should the need arise.

primarily in the securities business that have other types of financial operations that are still prohibited by the Bank Holding Company Act. These firms would have to divest these activities in order to buy a bank

Do you feel this exemption should be broadened to create more of a two-way street?

Mr. GOULD. Like you, Senator, we feel that, in terms of equity or fairness, there ought to be more symmetry. Ideally, there should be more symmetry than is embodied in this bill, although 80 percent is a fair step forward.

If one were to look at some of the activities that would make it impossible for securities firms to buy banks, we find a number of controversial activities that I think are impediments to getting something done. There are investment banking firms involved in the insurance business. There are investment banking firms involved in the real estate business, in a variety of services for their clients, which I think as a practical matter would provide further impediments to the passage of this legislation.

So, we would really go back to the statements in the text of my testimony which say we think this is a very good first step. It doesn't get us to totally symmetrical or totally equitable arrangements between investment banking firms and banks. It goes, in our view, a lot further than we have been, and I think that ultimate step should be the consideration that could come about by examining Senator D'Amato's bill in particular and the concept of a financial services holding company.

What I think, as desirable as ultimate symmetry and fairness may be, it strikes me that this goes a major first step and leaves open the opportunity for further steps at a later time.

Senator GARN. Well, but that is a political argument of what is possible. It cuts both ways. I think I have heard every political argument that exists over the last 13 years. So, on the one hand you develop opposition from some banking interests who don't want other financial firms in banking, but you gain some support by those in the financial services industry who would benefit.

It always cuts both ways. So, apparently you are making the judgment that it cuts more to getting the bill passed by not opening that exemption up further at this time.

Mr. GOULD. Well, having recently been through the bank-nonbank issues, which is an aspect of what you are mentioning, I don't feel it would be productive at this time to sort of get back in those waters.

I think you might say part of it is a political view, but I would almost prefer to say I think it's sort of a practical view of what degree of change can be accomplished in one step. It strikes me in many areas, not merely in my own experience but looking historically at major change in areas through legislation, that we don't see too many very broad-scale changes embodied in one step.

That was indeed one of the remarkable aspects of tax reform in 1986 where you had a major change in basic structure. But those come along, it seems to me, rarely I think there is the feeling that people want to go a step and see how it works and then see how a further step is justified.

So, if you will, falling back on those sort of observations, I think to try to achieve an ultimate structure in one step is not a practical consideration, and it also may not be a political consideration.

Senator GARN. I certainly understand the process. But we have made a small step in 1982 and haven't made one since, 5 years later. So, I agree with you you can't bite off the whole chunk all at once, but you have to do as much as you can. Congress seems to sit back and say, "Well, we did something," and at the rate of progress that we have been making I would not expect to be in the Senate anymore when we make a third step if we are lucky enough to make a second step.

Mr. GOULD. I think our view of S. 1886 is this is more than just a small step. In many ways I think this is a catch-up if you will of some of the periods to which you are referring.

Senator GARN. Senator Proxmire and I are the moderates, as I said yesterday.

Mr. GOULD. I am delighted to see you both in that role. I think this is a change from the law that has been in existence for over 50 years. It has become in some people's minds almost a religion. So, I think this represents a very substantial step, not merely a small incremental step.

Senator GARN. As a matter of fact, I was a year old when Glass-Steagall passed, and I have changed considerably over that period. [Laughter.]

Mr. GOULD. I do not mean by saying that either that I think you should take Senator D'Amato's bill or Senator Wirth's bill and put it on the shelf. I think it ought to be part of a spirited consideration by the committee, as the chairman suggested earlier. I think ultimately as the world continues to change, our financial institutional structure will have to change.

Senator GARN. Let me ask you one more quick question. Our bill principally focuses on securities activities. If we are able to pass some modified version of it, do you still believe the insurance and real estate moratorium should expire?

Mr. GOULD. Yes, sir. I feel that the moratorium in all its aspects, moratoria on all services should expire.

Senator GARN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

Mr. Gould, talking about Glass-Steagall a moment ago and the fact that our distinguished ranking member was only a year old when it was passed——

Senator GARN. I know you weren't born yet. [Laughter.]

Senator SASSER. I wasn't going to say that. But as a matter of fact, that is a fact. [Laughter.]

But the Glass-Steagall Act was enacted, as everyone knows, in response to a stock market crash. And there was a perception, and there is still a perception in some quarters, that securities activities of banks prior to 1929 contributed to the failure of the banking system, which reached crisis proportions in 1933. Whether that is accurate or not, that at least was the perception of Senator Carter Glass.

Mr. Secretary, I suspect that you are a student of financial history to a certain extent. What is your perception of the impact that bank securities activities may have had with regard to the crash that occurred in 1929?

Mr. GOULD. I think as to the safety and the soundness of the banking system, Senator, it was greatly exaggerated; that is, the impact that being in the securities business had was greatly exaggerated.

Senator SASSER. But was it a factor?

Mr. GOULD. Did it contribute to the collapse of the banking system?

Senator SASSER. Yes, sir.

Mr. GOULD. I think it is hard to identify any substantial bank whose bankruptcy was a function of the securities dealings. There were a number of abuses which wouldn't take place in the context of this bill. I think there were sales of securities without proper disclosure. I think if you go back to the hearings that were held at that time in Congress on the crash generally, you will find abuses which the SEC and other regulations were designed to prevent or modify.

So, I am not saying there weren't abuses. But solely speaking to to the issue of did underwriting activities lead to a major impact on the safety and soundness of the banking system, I think the answer to that in retrospect is no.

Senator SASSER. Let me rephrase that. I will agree with you—I would tend to agree with you that it was not the sole proximate cause. I think most people would agree with that. My question is: Was it a significant contributing factor, in your judgment?

Mr. GOULD. I don't believe so. I think the lack of liquidity—pointing fingers is easy after the fact—but perhaps the actions of the Federal Reserve prior to and following the crash were far more significant in terms of what happened to the banking system.

I would also want to point out, Senator, that what we are talking about in S. 1886 is not doing the activities commingled with depositor funds.

Senator SASSER. The way the structure is in this bill, it would have prevented even whatever problems existed back in 1929, because here we are talking about conducting those activities in separately capitalized, legally immunized subsidiaries, and not commingled in the bank itself.

Let me ask you this question. This is probably more the point. We have just had a very traumatic event occur in the stock market over the last 7 weeks. In your view, would we have gotten through that if we had not had Glass-Steagall?

Mr. GOULD. Yes. I think, actually, remarkably well. In preparation for this hearing, I asked some members of our group in Treasury to give me a rundown on how well major investment banking firms survived that period, based on published numbers of their net worth.

I am both pleased and amazed how little impact that stock market decline or crash, whatever you care to call it, had on the earnings and capital position of the firms, particularly if one were to take out two items: the British Petroleum underwriting, which was unique to four firms and, I hope, a nonrecurring event in history; second, the impact of arbitrage activities, which were the major contributors to losses within the Wall Street firms.

I would be very happy to share this information with you, but it is all publicly available.

Senator **Sasser.** I would be very glad to have that.

The **Chairman.** Could you submit that, Mr. Secretary?

Mr. **Gould.** What it shows is that in spite of the trauma and the compressed-time decline in the stock market, the major firms in Wall Street survived amazingly well. And if you analogize it and say the banks were in the same position as those firms, yes, they would have taken some hits, but not in any life-threatening manner.

PROPER TIME FOR LEGISLATIVE CHANGES?

Senator **Sasser.** You see, I think the trouble, the question that is troubling me on this subject, Mr. Secretary, and I think that troubles us to some extent about the chairman's legislation—and I may end up supporting it; I just don't know—but the problem we have is the sense that, yes, it's time to make some changes, legislative changes in the financial services industry or some changes need to be made, but is this the appropriate time?

You see all of these other danger flags flying. We see the United States for the first time in over half a century a net debtor country, for the first time since 1912, if memory serves me correctly. We see this enormous Third World debt that many of the banks are now having to write down, and we see the leaders of the countries south of the border now getting together, excluding the United States, and this appears to be a move preparatory to doing something about the debt that is owed by the countries south of the border to North American banks.

We see the problem of more bank failures in the last couple of years than we have seen since 1933. We see this enormous structural Federal budget deficit financed to a large extent with funds coming in from abroad.

To attract these funds, we've got to have reasonably high interest rates, which could have a recessionary effect on the economy here in this country. We see these long-term problems in the trade deficit, and the economy is noncompetitive on the international market.

Those of us who want to make some changes, who think that changes are going to have to be made, we have to stop and say is this the time to depart from what has been tried and true even though imperfect, and even though it needs modification is this the time in history that we ought to take that step even if it's just a half-step?

How do you respond to that?

Mr. GOULD. I hope, without seeming like a Pollyanna, I hope that I can take some of your observations and characterize them as arguments for change.

If there are problems out there in Latin American debt, then I think it is worth considering whether or not banks should not have the opportunity to diversify their income stream and not be dependent merely upon their old extensions of credit. I think that I would agree that there are problems with deficits, both domestic and trade, and other problems of that nature.

But I don't find those as arguments against allowing a banking system to move forward in ways that could make it more resilient to whatever problems are ahead of us as opposed to being in more danger from the underwriting process.

I think if we wait for a perfect time, we will be waiting for the millenium. In my own experience of some 35 years on Wall Street, I have seen a lot of market declines. Indeed, I have seen worse market declines than we have experienced so far. 1973–74 was a worse period than now. And these cycles are going to come along. They are part of the business cycle. That has not yet been eliminated, and we are going to have these cycles.

I think, therefore, it is important to say will there be some added benefits to changing the structure? Can it be done in ways that enhance rather than hurt safety and soundness? I think that is a very important avenue of inquiry.

In my view, this bill does that, and the trouble with Glass-Steagall is it defines banks' business in a way that maybe was applicable 50 years ago but clearly it is not applicable now. The commercial banks are losing, because of market forces, their traditional intermediary role in the extension of credit, and I think there is ultimately a safety and soundness problem for banks if we don't let them evolve into what modern delivery services require.

So, there is always risk in any change, and I think one has to, on balance, say where is it more likely to be good for the economy, which step is more likely keeping them behind walls that impede ultimately, in our view, their progress and safety and soundness, or allowing the company structure to extend and diversify their services.

We come out on the latter. Again, I think we will have many of the problems that you mentioned in our current world with us for some time.

Senator SASSER. One final question, because my time is up. But could you make an argument that one of the problems that banks find themselves in or a reason for some of the problems that banks find themselves in is that they have been forced to take lower-quality loans as a result of the better-quality business being skimmed off by other areas in the financial services industry, and by taking lower-quality loans this has depressed earnings and created some of the difficulties?

Is there any plausibility to that argument, in your judgment?

Mr. GOULD. Yes, sir. I think there is some plausibility to that, although I would probably in an extended discussion with you want to define terms a bit. Poor quality is often judged best after the fact. Let's take oil loans. There was a time when everyone thought the price of oil was going to go to $100 and the fact that people had a lot of oil loans was good, not bad. But it is true, I think, by the fact that the highest-quality companies, industrial companies, commercial companies in this country, were the first to access securities markets and bypass the banks for their credit.

That bears on your point. The high-quality companies went to the commercial paper market or in other ways achieved securitization funding rather than bank funding, leaving inevitably the lesser credits to be dealt with by the banking system.

Part of it also, I think, comes about from concentration. You mentioned earlier, Senator, that we have had a record number of bank failures. Statistically, that is true, but in fact most of those banks, if you look at them, were either smaller banks heavily concentrated in the agricultural area, or there were problems with banks heavily concentrated in an industry, like some of the banks in Texas, where their geographical limitations were also a problem in the safety and soundness sense.

One of the benefits that we see from this bill is the diversity of income streams. It is also, in our view, that some of that same diversity could result from greater interstate banking, where one is not as a banker limited to just agricultural loans or heavy concentrations in oil or real estate, which is also affected by oil prices.

But I think your general principle has some validity, that as the better credits find it more efficient and cheaper to access securities markets directly without the intermediation function of the bank, banks are left with the possibility of lower credits for the panoply of credit which they can extend.

Senator SASSER. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Dodd?

Senator DODD. Thank you very much, Mr. Chairman.

Mr. Secretary, I appreciate your being here this morning.

Let me, if I can, run through a series of questions with you. First of all, I note in your testimony that we all agree on the need to strengthen the banking system to ensure the equity of the system. Those are concepts we all agree with. The question is how to get there. And there may be some differences.

I happen to feel strongly—and I think again it is one of those facts that is really not debatable—one of the most serious problems we face in addition to domestic State legislative actions, and what is going on within the private sector, is the international competition that our institutions are facing.

INTERNATIONAL SUPERVISORY BODY

In no small measure, I think one of the reasons that we are engaged in this process is because of what is happening internationally. Yet, in neither of the proposals, or in any of the proposals, I should say, that have come forward have I seen any suggestion at all about establishing some sort of international supervisory body, that would try to put some order into the international system so that competitive equity isn't something we just talk about here but is something that would be international.

I wonder if you might comment first of all on whether or not you think that is wise, whether or not you think we are making a mistake by not pursuing it more aggressively, and whether or not we ought to include protective legislation.

Obviously, we can't propose an international supervisory body alone, but it seems to me that there ought to be more of an aggressive effort on the part of the administration to establish some sort of a body, or at least begin to move in that direction.

Without it, it seems to me if we do all these things ourselves and nothing happens internationally, we may in fact be doing some significant damage to ourselves internationally.

Mr. GOULD. I would agree with your general thrust that a greater degree of international cooperation on standards, let's say, for example, more common standards for bank capital, would be helpful. I would agree with that.

A real-life example in the last month or so shows how interrelated our markets are, and those perhaps are the stock markets. But I think it's clear that the rest of our institutions are interrelated in terms of being vulnerable, the domino effect, credit problems or whatever the situation may be.

I think that is one worth pursuing. Obviously, we can't legislate for other countries, so that is an impediment in itself. I would point out that the Federal Reserve for some time has been attempting to work in that direction and indeed the other bank regulators have been involved.

We have recently had some degree of agreement, for example, with Great Britain on common capital standards. They are, in a fairly crude way, risk-based, but they have been set forward. There are negotiations going on now with the Common Market and Japan in that very instance. That is an attempt here to have a more level playing field, if you will, and also have high safety and soundness concerns because of the implications now for all worldwide financial institutions. I think that should be encouraged, that should be pushed, that should be recognized.

Senator DODD. Could we help in that process by creating some sort of conditionality? It seems to me that we have not been allowed enough access to Japanese markets, for financial services, for instance, yet we have been extremely generous in this country in similar activities.

Mr. GOULD. In defense of the Treasury, Senator, I would have to say that there has been a tremendous effort for some time now to create an atmosphere of national treatment in Japan.

Senator DODD. I am not talking about your efforts.

Mr. GOULD. It is just slow going. I think all of this is slow going. In fact, if you were to ask me—this is just a judgment—but if you were to ask me when do I think we might get some real progress on the type of agreement the Federal Reserve has negotiated with the Bank of England, I would say we are several years from that.

These international negotiations by their nature, the friction of international requirements and local nationalism, just seem by their nature to take years.

Senator DODD. Let me move specifically to the legislation introduced by our chairman and the ranking minority member. What I think is inherent in the presumption or perception about a repeal of Glass-Steagall—of course, the legislation does more than that, but at least that is the general thrust of it—is that we are effectively creating a competitive equity situation; that is, the two way street—banks can get into other activities, other financial services can get into banking.

It is, in the words of our ranking minority member that have been used on so many occasions, the level playing field, in a sense.

I would argue with you, however, that while in theory that is what the Proxmire-Garn legislation attempts to achieve, in practicality it doesn't.

I would like for you to comment on this. You know, certainly, that securities firms have insurance activities, real estate activities, and under this proposal they would have to divest themselves of those activities while, of course, banks would not in that situation at all, which doesn't sound to me as much like competitive activity. You have got a lot of securities firms that are tied to commercial activities.

Obviously, what we are talking about here is not so broad as to eliminate the distinction between banking and commerce. So, you have the same problem, it seems to me, for securities firms in terms of the theoretical two-way street we are talking about here.

It has been suggested we ought to wait until a later date, see how this emerges, and so forth. So, an argument some of us were using last year with the moratorium is that we should try to provide an environment so we can deal with these issues.

What I would suggest to you here is that if you really want to achieve that two-way street, we ought to be talking about a broader deregulation approach, perhaps one that includes affiliations between banks and other commercial firms as well as banks and commercial firms. If we are really going to move in that direction, rather than the inequity which I see in just the repeal of Glass-Steagall, it seems to me to be staying with the basic notions contained in the Proxmire-Garn legislation.

Wouldn't it make more sense rather, to put the question to you, to require banks to put all their securities activities into separate affiliates of a holding company in order to assure competitive equity with the securities firms? If we choose to follow that narrow course suggested by the legislation that is being offered and leave other new activities for a later time, it seems to me that we would then act to keep banks out of the insurance business, since we obviously wouldn't let insurers into the banking business.

I wonder if you might comment on that general concern that you have heard, I am sure, before? It does strike me as being rather obvious on its face.

Mr. GOULD. As Senator Garn and I were discussing earlier, I think this is a very good first step toward ultimately a more symmetrical structure or indeed more competitive equity.

Senator DODD. But you would agree that it is certainly not a two-way street if we adopt this legislation?

Mr. GOULD. No, I would view it as more of a two-way street than we have had, Senator Dodd. But not a total two-way street. For example, a securities firm with 80 percent of its activities in securities can do it, but that other 20 percent doesn't make it yet.

But inherent in your comments, I think, are two things worth considering. One, to wait for perfection is, in my view, to assume that there is nothing wrong enough now that requires near-term action, since waiting for perfection almost by definition is a longer-term struggle.

Senator **Dodd**. I am not suggesting that. I am suggesting that if we are to do it, we ought to do it right.

Mr. **Gould**. Well, Senator D'Amato's bill, as I understand it from very quick perusal last evening, goes a substantial step in that direction, for example.

Senator **Dodd**. Do you have problems with that? Would you eliminate the distinction between banking and commerce, if you had your way?

Mr. **Gould**. That has not been a position which the Treasury or the administration has held, and we do not have an official position.

Senator **Dodd**. Just personally—you have been in the business a long time—would you eliminate the distinction between banking and commerce? Yes or no?

Mr. **Gould**. I think it's hard to answer you. I am not dodging your question at all. But I think a yes-or-no answer, you know, I think you and I ought to have a much longer discussion of that in terms of what accompanies such a joining of commerce and banking in terms of undue concentrations of economic power, in terms of the danger of allocating credit, a variety of real-world concerns.

Senator **Dodd**. We are going to hear from Bob Litan later on. What do you think of Bob Litan's proposal, the narrow bank proposal?

Mr. **Gould**. I have read it. It is an approach. It is an approach that has one particular benefit, I think, which says since the Federal safety net is limited to a narrow proportion of the business and the rest of it is caveat emptor, go do what you want, in essence, but do it at your own risk.

I think that is in keeping with a free-market philosophy. I think that is in keeping with spurring innovation and allowing people to do things. I think that has some merit to it.

Again, having observed the process here a bit, I think as long as we can take some incremental steps that do not by their nature preempt broader steps later on, it is worth proceeding without ever saying that this is the last step that should be taken.

Senator **Dodd**. Mr. Chairman, I have a couple of more questions. I don't know if anyone else does.

SOUTH DAKOTA LOOPHOLE

Senator **Dodd**. Another thing that we are looking at is the Bank Holding Company Act and the State-chartered banking activities. There is the South Dakota loophole. In light of those changes, shouldn't we close the South Dakota loopholes and open up the other end of the pipeline, so to speak.

Do you support that?

Mr. **Gould**. Yes, in the sense that the State shouldn't allow something to be done by a firm in the State, beyond the State that isn't allowed in to the State.

Senator **Dodd**. So we ought to close that.

The Barnard approach, requiring a holding company to stand behind its bank to prevent losses to the Federal Deposit Insurance Funds, what do you think of that, very quickly?

Mr. GOULD. The capital of the bank is a cushion between risk and the Federal Deposit Insurance Funds. Whether you can have a commitment that the holding company provides an axiomatic further cushion, I am not sure is something that we have explored in any detail.

Senator DODD. They are getting involved in riskier business this time. You know, someone's got to pay for this if they screw up.

Mr. GOULD. Again, sir, in the structure of this bill, we are putting the new activities into the holding company and away from the insured deposit base. I think there has always been the philosophy that a bank holding company was a source of strength to the underlying bank, in times of adversity, and I think that remains a valid concept. But the very fact that these new, if they are, indeed, riskier activities, and I think that is arguable, are to be conducted, they are to be conducted in a holding company with, in the case of this bill, an absolute lending prohibition, other than Government bond clearing and fully collateralized Government bond clearing.

We have an absolute prohibition of lending from the bank to those affiliates.

So I don't see that that is putting riskier activities in the bank. Indeed, it is separately capitalized and not part of the minimum capital standards of the holding company itself.

Senator DODD. A last question to you.

You know, and all of us know, the tremendous innovation that has come out of independent bankers and independent insurance agents. It's been significant over the years and what we are talking about here is making changes that would have a significant impact on smaller banks. The independent agents, obviously, are legitimately concerned about what might happen here, if you allow banks to engage in their activities and potentially put them out of business.

I would like to hear your comments on what you think might be done to minimize the loss. Put aside the questions of whether or not you think these people ought to be out of business. Innovation has so often come from the smaller operators.

What impact do you think that has, No. 1. No. 2, from 1977 to 1983, we saw a 12-percent decline in the number of consumers with checking accounts. Obviously, there's going to be more concentration as a result of this legislation.

What safeguards would you suggest to see to it that that trend goes in the opposite direction? The obvious danger of more consumers without checking accounts—it seems to me we want to try to reverse that tide. How do you handle that problem and the degree of concentration that this legislation obviously envisions?

Mr. GOULD. My problem is with your premise that the repeal or amendment of Glass-Steagall, would have as one of its natural byproducts or fallouts greater concentration within the banking industry.

I think if there is going to be greater concentration within the banking industry, that is fully as probable as the result of holding it behind the walls of Glass-Steagall and saying you can't get in any other businesses than the ones you're in.

Senator **Dodd**. Would you argue for about four large banks?

Mr. **Gould**. No, sir, only in the view of the New York Times. And as fond as I am of that newspaper, I would not vouch for the accuracy of all their articles. [Laughter.]

So I think are should be concerned over extremes of concentration. To me, the size of banking organizations should be a function of the competitive marketplace. If there are services being delivered which require some economy of scale, I think the market will tell us that.

I don't think that there is any basis to propose, as in my statement to the chairman earlier, merely in terms of the aggregation of assets, that that is a more efficient way to run a banking business than some other way.

We have a major diversity of banking institutions at the moment. If Chemical Bank has to affiliate with Texas Commerce, that is driven by really basic economics, and I don't think these should be dictated from an abstract source.

Senator **Dodd**. Obviously, that's a fact. I am talking about the effects of that. There will be effects to suggest otherwise is ludicrous. There will be, I suspect, less access. You are going to find fewer smaller bankers, fewer independent agents. The question is, what happens? Is there anything we ought to be worried about?

Mr. **Gould**. You've seen the rise of things, like the credit union, to fill niches where banks were not providing that service. You've seen expansion of activities in the S&L's. In a competitive environment, it seems to me, where services are not being provided, the very innovation that you talk about will, in the end, provide it.

I think, if I can phrase it this way, I think there are two approaches to trying to assure that the consumer has adequate service delivered to him at a proper price. One approach is to take the existing institutions and the existing structure and regulate and mandate and say, "By God, if you're going to have that banking charter, you are going to have to provide the following services."

In my view, that is a less attractive way to do it than the other way, which is to say, let a lot of people get in there and freely compete, and the competition will provide services. The trouble with the mandatory or regulatory approach, in its extreme, is, that there are so many ways in the operations of those organizations to subvert the dictate from on high. To me, when there is a need for a service that isn't being filled, the pluralism of this economy will create the institution to provide it, providing we keep the system competitive.

Senator **Dodd**. Thank you very much. Thank you, Mr. Chairman. I apologize.

The **Chairman**. Thank you, Senator Dodd, and thank you, Secretary Gould, for an excellent job. We appreciate very much your fine testimony and your responses.

Next we will have two outstanding scholars testify—Robert Litan, senior fellow at the Brookings Institution, and Dr. William Haraf, J.E. Lundy Scholar and director of the Financial Markets Project of the American Enterprise Institute.

Gentlemen, you have been very, very patient. We apologize for the late hour.

Mr. Litan, go right ahead. As you know, you have 10 minutes each.

STATEMENT OF ROBERT E. LITAN, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. Litan. Thank you very much, Mr. Chairman. Nice to see you again.

I will briefly attempt to summarize my testimony, but before I turn to the specific legislative proposals that are before you, I have two broad comments.

First, I would like to congratulate you and other members of the committee for bringing this debate to center stage. There is now a clear consensus within the academic community and within the regulatory community, that a responsible dismantling of the barriers between banks and other financial enterprises is both desirable and necessary.

And Mr. Chairman, your own statement introducing S. 1886, presents a clearly stated, succinct and powerful case for removing the barriers between banking and the securities industry.

Second, restructuring is inevitable over the long run, even if Congress fails to act. This is a very important point, because the States are already doing the job by gradually expanding the activity authority of the banks they charter. If Congress does not act, that process will only continue. Nevertheless, in my opinion, the Nation would be far better served by comprehensive reform now at the Federal level, not because I dislike the dual banking system, but rather because the sooner restructuring is accomplished for all financial institutions, wherever they do business, the more quickly consumers will benefit and banking and securities lawyers and lobbyists, as well as members of this committee, can go on to other more productive activities.

FEDERAL LEVEL OF REFORM PREFERABLE

Indeed, for these and other reasons, I believe that federally driven comprehensive reform is preferable to the interesting proposal recently offered by Representative Tom Carper, who would delegate the entire job back to the States.

Now, let me turn to the two specific bills before you. I didn't have a chance to look at the D'Amato-Cranston bill, but it certainly looks like it's going in the right direction.

First, the threshold issue is how far should you go? Should you stop with banking and securities, or should you go all the way to more comprehensive reform?

From solely an economic point of view, and I am not going to get into the politics, unless we do so in Q and A, the answer is simple. Go as far as possible.

While the removal of Glass-Steagall will clearly provide benefits, such as lower underwriting costs and lower advisory fees, these will only be indirectly seen by consumers. But if you allow bank holding companies to enter insurance agency and real estate brokerage, among other areas, consumers will see the direct benefits. It is no accident that in Massachusetts and New York, banks provide insurance at very low cost, and I find it hard to believe that real estate commissions would stay stuck at 6 percent, if bank entry into that line of business would be permitted.

Indeed, I think you would see a lot more discount real estate brokers, just as you see a lot more discount securities brokers, when banks are allowed to enter that business.

Second, where should you put the new powers? In holding companies, deregulated banks or subs of the bank? I side with the holding company approach that is reflected in each of the bills before you.

There are several problems with expanding powers of banks directly.

First, if you do that, banks could then take advantage of the incentives for risk-taking created by deposit insurance to expose themselves and the FDIC to greater risk.

Second, if nonbank activities located inside or beneath the bank were to fail, the bank's capital would then be directly impaired, and, in fact, the FDIC could be called upon to ensure not only the banking industry but the securities, insurance, real estate and other businesses as well.

Now, the FDIC has recently recognized these problems and they've proposed that bank investments in subsidiaries not be counted toward bank capital. While this may work for activities directly in bank subsidiaries, it probably can't work if the expanded powers are carried out by banks directly, because then the capital for the various activities would be blended together.

More important, even under the FDIC proposal, banks would be able to use federally insured funds to invest in other enterprises, an advantage nonbank individuals and firms do not enjoy.

Critics of the holding company requirements say it is too expensive, even under the expedited procedures of Proxmire-Garn. If you believe this is a problem—that is, a political problem—then.

One way around it would simply be to exempt small banks from the holding company requirements, on the grounds that smaller institutions do not pose the kind of systemic danger that large banks do. Alternatively, you can keep the holding company requirement but exempt very small bank holding companies from Fed supervision. The third issue is: Which agency should be responsible for supervising new financial conglomerates?

Proxmire-Garn takes an interesting approach to this question by setting up an 80-percent test for securities firms not heavily engaged in banking. I understand fully the reasons why you put in the 80-percent test—because you don't want to have intrusive Federal Reserve regulation of conglomerates primarily involved in the securities industry.

I would point out, however, that whatever percentage test that is used may create an incentive for financial organizations to adopt clever accounting techniques or to push their bank activities off balance sheets, in order to avoid Fed supervision. It is a problem. Maybe we can get to it in Q and A.

The Graham-Wirth bill, in my opinion, raises far more troublesome issues by suggesting the creation of a 15-member Financial Oversight Commission. I am skeptical. Why create another regulatory body, when the United States already has the most complicated system of Federal regulation in the world? If the objective here is to expand powers of organizations that own banks, why not simply amend the "closely related to" test of the Bank Holding Company Act and replace it with the word "financial" or something like that instead, and specifically allow securities real estate and insurance powers, and then leave the regulatory responsibility, however broad it is, with the Fed, where it already is? I see no need for creating another agency with all those people on it.

The fourth and most important issue before your committee is how to insulate the bank from problems with its affiliates. In my opinion, Proxmire-Garn does reasonably well on this score by imposing a series of detailed restrictions on transactions between banks and their affiliates and between banks and the customers of their affiliates.

However, as some of you know, I think there is a better way to attack the insulation problem. That is to require that any conglomerate that desires to engage in activities beyond the Bank Holding Company Act, to restructure its bank into a narrow bank. Such a bank would only hold obligations issued by the Federal Government or a Federal agency, such as FNMA's or GNMA's.

As a result, narrow banks would essentially be run-proof, unlike conventional banks, under any of the proposals before you. Because all lending in such organizations would be conducted by commercial finance affiliates funded by uninsured debt and equity rather than by banks operating within insured funds, there would simply be no conflict of interest concerns. As I explain in my prepared testimony and in the attachment thereto, there would be transition rules to minimize strains on the securities markets and an exemption from the narrow bank requirement for small banks.

Narrow banking, in my view, removes the need for the kind of detailed restrictions of Proxmire-Garn and other similar proposals. Indeed, some of these restrictions may be more problematic than meets the eye.

PROPOSED RESTRICTIONS COULD BE A PROBLEM

For example, the law may say that a bank is not to lend to an individual for the "purpose of purchasing securities underwritten by the security's affiliate", or the law "may prevent banks from lending during the underwriting period."

But how can regulators really know what the money is used for, when the loan is made? After all, money is fungible. Now, I am not saying these problems are so insuperable that we ought not to proceed with reform. I am simply pointing out that in an ideal world, I would rather have narrow banking than any of the bills on the table.

But of course, this is the real world, and narrow banking is not on the table. So I would clearly support the Proxmire-Garn provisions having to do with insulation instead.

I have one caution, however, to add about a feature that is common to both Graham-Wirth and also Proxmire-Garn. Specifically, I refer to a provision that allows the supervisory authority to force the divestiture of the bank, if its capital falls below a certain minimum.

While this feature might work, it also may not. Divestiture orders in the real world are likely to be vigorously contested in court, which could tie up the supervisory agency for years. Some banks may simply be too large to divest, especially if they have problems.

I should remind you that Continental Illinois was on the shopping list for several months. The regulators couldn't find anybody to buy it.

Finally, for these reasons regulators may simply be reluctant to order divestiture, especially when they are under political pressure, as they frequently are, to exercise forbearance.

One final point on the insulation issue.

If the political price for financial restructuring is a prohibition on cross-marketing, the effort in which you all have engaged will simply not have been worth it.

So I strongly advise against any restrictions on cross-marketing.

The last issue relates to asset concentration issue, which I address briefly in my testimony.

My basic point is that I don't see the inherent evils of large organizations if they do not acquire excessive market power. This is what the antitrust laws are designed to prevent.

However, I also recognize that asset concentration limits could be procompetitive by forcing de novo entry and also by forcing the purchase of smaller firms by organizations with the intention of building them up later.

On balance, I see no overwhelming downside to putting concentration limits in. If they are viewed as politically necessary for getting a bill through, then fine, so be it.

That is the end of my comments, and I look forward to questions.

[The complete prepared statement of Robert E. Litan follows:)

Financial Restructuring

Which Way for Congress?

ROBERT E. LITAN

Unless Congress acts now, far-reaching state reforms will shape the system. "Narrow banking" is a way to break Washington's political stalemate and to maximize the social benefits from reform.

Revolutionary changes have hit the U.S. financial services industry in the 1980s. Bank deposit interest controls have been removed. The barriers to interstate banking are falling. While banks and thrifts continue to fail at an ever increasing pace, federal policymakers are considering whether to overhaul the entire financial system—by removing the legal segmentation between banks and other financial and nonfinancial enterprises.

To a significant degree, however, the horse is already out of the barn. Many nonbanking firms, including such household names as American Express, Merrill Lynch, and Sears, have already found their way into banking by exploiting one or more crevices in the archaic legal structure originally designed to separate banks from other enterprises. Meanwhile, U.S. banking organizations are now engaging in a range of nonbanking activities in foreign countries—notably corporate securities underwriting in London—that they are precluded from pursuing at home.

If federal legislators fail to act soon to "level the playing field" among different providers of financial services, it is likely that state legislatures will fill the void. As shown in Table 1 (page 39), most states already allow the banks they charter to enter at least some financial activities—especially real estate development and insurance agency—that are currently off limits to "national" banks (or those chartered at the federal level by the Comptroller of the Currency). Certain states—Florida, New Jersey, and North Carolina—allow their banks to compete across the full spectrum of financial activities. Significantly, many states have granted their banks broader powers in just the past few years. The states are likely, if anything, to be even more aggressive in liberalizing the activity authority of their banks in the years ahead after the move-

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Testimony of Robert E. Litan[1]

Senior Fellow, Economic Studies, The Brookings Institution
and Counsel to Powell, Goldstein, Frazer & Murphy

before the

Senate Committee on Banking, Housing and Urban Affairs
December 2, 1987

Thank you, Mr. Chairman, for inviting me to appear before the Committee today.

I want to begin by congratulating you and the other members of the Committee for considering the fundamental reforms of our financial system that have been proposed -- both S. 1886 sponsored by Chairman Proxmire and Senator Garn and S. 1891 sponsored by Senators Graham and Wirth. There is a consensus within the academic and regulatory communities that the restructuring of our financial laws is long overdue. In particular, the evidence that I have examined over the past several years clearly suggests that *under the appropriate structural conditions* consumers of financial services -- households and corporations -- would clearly benefit if the restrictions that now imperfectly segment banking from other activities were removed.[2]

Nevertheless, the debate about whether the financial system *should* be restructured is fast becoming academic. While Congress has been deliberating what course of action to take the states have been quietly expanding the authorized powers of the banks they charter. In fact, most states now grant their banks broader product-line freedom than the Comptroller is permitted to allow for national banks.[3] If Congress fails to act sometime in the near future, the states almost certainly will settle the financial product-line debate just as they have almost settled the once bitter contest over interstate banking.

The bills you have requested testimony about this morning can be viewed as attempt by the Congress to wrest the initiative from the states. I think such action is appropriate -- not because I oppose the dual banking system, but because the sooner restructuring is accomplished for

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1. The views expressed here are solely those of the author and should not be ascribed to the institutions with he his affiliated, their trustees, officers, partners or employees.

2. I set forth this view more fully in *What Should Banks Do?*, published by the Brookings Institution in September 1987.

3. See "Financial Restructuring: Which Way for Congress?", *Challenge*, November-December 1987 (attached).

all financial institutions wherever they do business the better off we will all be. Consumers will benefit more quickly. Closer to home, millions of dollars (or over several years, even billions?) will be saved on lawyers and lobbyists. And members of this Committee can allocate their scarce time and political capital to other issues.

For these and other reasons, in purely economic terms the nation would be better served by a comprehensive federal solution now than by the legislation recently offered by Rep. Tom Carper, which would effectively delegate the whole restructuring issue to the states (by equalizing the powers of state chartered banks and national banks operating in the same state).

I would now like to address a number of generic issues that are raised by both the Proxmire-Garn and Graham-Wirth proposals.

The threshhold question is how far should Congress reach in reforming the financial laws? To be concrete, should only the banking-securities issue be settled (by repealing Glass-Steagall), or is the more comprehensive approach embodied in the Graham-Wirth proposal (itself modeled on the recent restructuring proposal offered by Gerald Corrigan) more desirable?

Again, if economic considerations alone are to be considered, a more comprehensive approach is preferable, especially for consumers. To be sure, removing the Glass-Steagall barriers would provide benefits -- lower underwriting costs and advisory fees paid by corporations. But consumers won't directly observe these savings. Consumers would directly benefit, however, if banking organizations were able to sell insurance and broker real estate. It is no accident that in Massachusetts and New York, which allow savings banks to sell life insurance, bank-provided insurance is generally the lowest cost. Indeed, even the insurance industry has aknowledged that the current system of delivering insurance is inefficient.[4]

I also find it hard to believe that with more competition in the real estate brokerage industry -- especially from technologically sophisticated banking organizations -- real estate commissions would stay stuck at the "customary" 6%. In fact, we are just beginning to see the development of "discount" real estate brokers. If banking organizations were permitted to broker real estate, I suspect you would see a lot more such "discounters" -- just as banks have aggressively pushed discount securities brokerage.

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[4] American Insurance Association. Expansion of Banks Into Insurance (New York, AIA, 1983), pp. 16-20.

There is also a case for allowing banking and commercial organizations to mix -- as is already the case with firms like Sears. We'll never know if there are synergies or "economies of scope" between banking and commercial firms unless the current legal barriers are removed. Commercial operations may also bring financial strength to a banking organization. At the same time, however, the mixing of banking and commerce may pose significant risks -- especially of conflicts of interest, which could in turn threaten bank safety. For these reasons, I favor ending the banking/commerce distinction only in the context of the "narrow bank" proposal (described in the attached article), with which I know some members of this committee are familiar, and which I will later discuss briefly.

Nevertheless, I understand the practical political constraints under which this Committee -- and indeed the entire Congress -- operates. If Congress can agree this year on a bill that only levels the playing field between the banking and securities industries, then in my book that would be a major accomplishment. Enactment of the Proxmire-Garn bill in its current form would be an even bigger accomplishment -- since this proposal would expand the "closely related to banking" test in the Bank Holding Company Act to take into account "technological or other innovations in the provision of banking or banking-related services". This language would at least permit the Fed to adapt the legal structure over time to continued changes in the financial marketplace. But I would prefer a more comprehensive legislative approach from the outset.

A second important issue which I know has occupied the attention of some members of this Committee is: Where should the new bank powers be vested, in subsidiaries of bank holding companies (BHCs), in subsidiaries of banks, or inside banks themselves? Both the Proxmire-Garn and Graham-Wirth proposals opt for the holding company format. In my view, this is the correct approach.

There are several related problems with giving expanded powers directly to banks (or their subsidiaries), all stemming from the fact that banks have access to federally insured deposits. First, as virtually all academic observers of the banking industry have pointed out, deposit insurance blunts incentives for banks to avoid risk (especially if banks have little or no capital). If, therefore, banks can engage in new activities directly, they may take advantage of their freedom to expose themselves and the FDIC to greater risk.

Second, if non-bank activities located inside the bank (or directly beneath it) should fail, the bank's capital will be directly impaired. In the process, the FDIC may end up insuring not only the banking business, but the securities, insurance, real estate and any other businesses that banks are allowed to enter.

The FDIC recognizes these problems in its recent report on financial restructuring, *Mandate For Change.* It proposes to solve them by not allowing banks to count as part of their capital any investments they have in non-bank activities. This "solution" is imperfect, however. It can be implemented if the non-bank activities are conducted in bank subsidiaries (for then the bank's investments in those activities -- in the form of stockholdings -- are clearly segregated); but it would be difficult, if not impossible, to implement where banks are *directly* engaged in non-banking businesses (and therefore devoting the same pool of capital to both bank and non-bank enterprises).

More important, even under the FDIC's proposal, banks could use *federally insured funds* to invest in other enterprises. This would be patently unfair to investors not affiliated with banks who must raise their capital themselves or on the open market without federal guarantees. Indeed, this is another reason for not delegating the restructuring job to the states since they will simply carry it out by expanding the powers of banks directly.

Nevertheless, critics of the holding company structure have legitimately pointed to its expenses, particularly for small banks. The Proxmire-Garn bill attempts to solve this problem by providing an expedited procedure for forming bank holding companies. Still, if the small bank problem proves to be politically difficult, the Committee may want to consider exempting banks below a certain size (measured by assets or deposits) from the holding company requirement. I realize this would muddy the regulatory waters. But small banks do not pose the dangers of systemic failure that are posed by the collapse of larger banks. Alternatively, the Committee could require all banks to conduct their expanded powers through holding company affiliates, but exempt smaller bank holding companies from Fed supervision (unless their bank subsidiaries were Fed members).[5]

One final comment on the "location issue". Although the Proxmire-Garn bill generally requires securities activities to be carried out through a holding company subsidiary, it would allow banks directly to underwrite municipal revenue bonds. I understand why: if banks can now underwrite general obligation municipals directly, then why not revenue bonds as well? In fact, however, I am aware of no empirical evidence demonstrating that municipal revenue bonds are somehow less risky to underwrite than corporate or asset-backed securities. In fact, because they are not as liquid, municipals may be more risky to underwrite than other types of

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5. The Proxmire-Garn draft proposal already recognizes the distinction between larger and smaller banks by exempting banking organizations with less than $500 million in assets from the general prohibition on banks' sharing of officers and directors with their securities affiliates.

securities. Accordingly, if the Committee's interest is in minimizing risk to the bank, I think a cleaner break would require *all* municipals underwriting to be carried out in the securities affiliates -- leaving banks to underwrite directly only federal securities.

A third issue is which agency (or agencies) should be responsible for supervising the expanded banking conglomerates? Although logically it doesn't have to be, as a practical matter the answer to this question hinges on the answer to the previous one: if banks can conduct expanded powers directly, then the FDIC and/or the Comptroller would be in charge; if the holding company format is required, then regulatory authority would be lodged in the Fed or the Federal Home Loan Bank Board (in the case of thrift holding companies). The proposals before the Committee, however, raise two interesting twists.

The Proxmire-Garn bill would exempt bank holding companies from Fed supervision if they were 80% in the securities business, measured by consolidated revenues or assets. I understand the purpose of this provision -- to minimize regulatory burden on financial conglomerates overwhelmingly involved in the securities business. However, I would caution that any percentage test will give financial organizations -- most of whom would prefer to avoid Fed examination -- incentives to adopt clever accounting techniques or to push bank activities off the balance sheet in an effort to escape Fed supervision.

The Graham-Wirth proposal goes much further, however, and suggests the creation of a new 15 member Financial Services Oversight Commission. Frankly, I am skeptical. The US already has the most complicated system of financial regulation and jurisdiction in the world. Do we really need to make it worse by creating *another* financial regulatory body? In addition, why extend regulation to so-called "commercial" or "financial" holding companies -- those involved in finance and/or commerce, but not banking. Why do we need more regulation of the Sears, Merrill Lynches, and GE-Kidder Peabodies of the world? Finally, if the objective of the Graham-Wirth-Corrigan proposal is to expand the activities of organizations that own banks, then why not simply amend the "closely related" test of the Bank Holding Compnay Act -- putting in its place a "financial" test and specifically allowing securities, insurance and real estate activities -- and then leave regulatory responsibilities with the Fed, where they are now?

The fourth issue -- insulating banks from problems in their affiliates -- is the most important issue this Committee will address. Proxmire-Garn addresses it by imposing a series of rules and restrictions on transactions between banks and their securities affiliates, and between banks and customers of their affiliates (both purchasers and issuers of securities). The Graham-Wirth-Corrigan proposal, meanwhile, largely delegates the resolution of the insulation problem to the Oversight Commission to handle problems as they arise. In extreme cases, the

Commission could order the divestiture of any activity -- including the bank -- from the holding company.

As some of you know, I believe the ideal solution to the insulation problem is to require any banking conglomerate engaging in activities outside the current Bank Holding Company Act to restructure its bank into what I call a "narrow bank". Such a bank would hold only Treasury obligations or instruments insured by a federal agency, such as "Ginnie Maes", "Fannie Maes", or "Sallie Maes". Because they would hold only highly-liquid safe securities, narrow banks (unlike conventional banks under either Proxmire-Garn or Graham-Wirth) would be "run proof" if their affiliates went down. Moreover, because narrow banks could not extend loans -- to anyone -- they could not bail out affiliates, either directly or by lending to their customers. For the same reason, there would be no conflicts of interest problems. All lending by diversified banking conglomerates would be conducted out of commercial finance affiliates, funded by uninsured debt and equity, just as GE Credit, Commercial Credit, GMAC, and other finance companies are funded today. Appropriate transition rules would allow existing bank holding companies desiring to exercise broader powers to transfer their loans to new finance affiliates over a 10 year period -- easing pressures on securities markets. Finally, small banks would be exempted from the narrow bank requirements.[6]

Without getting bogged down in a detailed discussion of this proposal I would just point out that narrow banking removes the need for many of the detailed inter-affiliate restrictions written into the Proxmire-Garn proposal. If lending in diversified conglomerates must be funded by uninsured money, then I believe there is little need for these rules, which may be difficult to enforce. After all, a rule may say that a bank is not to lend to an individual for the "purpose of purchasing securities being underwritten by the bank's securities affiliate", but how can regulators really know what the purpose is? Money is fungible. The same comment applies to rules preventing banks from lending to companies for the "purpose of repaying securities underwritten by the bank's affiliate".

Nevertheless, "narrow banking" is not before you today. What about the insulation provisions of the bills on the table?

Even though the inter-affiliate restrictions written into the Garn-Proxmire bill may require extra vigilance by the regulators, I believe they are satisfactory and would remove most of the risk of bank affiliations with securities operations. One additional restriction the Committee may want to consider, however, is a rule preventing securities firms from maintaining deposit accounts at their affiliated banks. This would eliminate one of the nightmares expressed by some Fed officials --

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[6] For a full description of the narrow bank proposal and objections to it, see What Should Banks Do?, pp. 164-89 and attached article.

that a bank affiliate could run a big overdraft at its "sister bank" that unravels the payments systems operated by FedWire and/or CHIPs.

I have a caution to add about one insulation feature that is in both the Proxmire-Garn and Graham-Wirth bills: a provision allowing the Fed or the Oversight Commission to order the divestiture of the bank from the rest of the diversified enterprise if the bank's capital falls below a certain minimum. Such a "bear down" requirement (as Citibank Vice President Thomas Huertas has called it) may very well work. But it also may not.

Divestiture orders are likely to be vigorously contested in court -- with lawyers fighting about the bank's "true" level of capital (whether measured at market value, by generally accepted accounting principles, or even by more liberal "regulatory" accounting principles) -- which could tie up the supervising agency for years. In addition, some banks may simply be too large to divest, especially if they are plagued with problem loans. Remember that only three years ago, no buyer could be found for Continental Illinois. Finally, for both of these reasons, regulators in practice may be extremely hesitant to impose the divestiture remedy when it is called for. In fact, strong political pressues have recently been brought to bear upon regulators to prevent the closing of many technically insolvent banks and thrifts.

These problems with making a "bear down" requirement work are another reason I favor the narrow banking approach. Narrow banks invested only in safe, liquid securities are far less likely to get into the kind of trouble that would merit their divestiture, and even if they did, their assets would be easily valued, making it extremely difficult for clever lawyers to defeat agency divestiture orders.

One final point on the insulation issue. I strongly urge the Committee not to accept proposals to limit the cross-marketing of services by banks and other enterprises with which they may be allowed to affiliate. If the political price for restructuring the financial services laws is a prohibition on cross-marketing, the effort will not have been worth it.

The last issue I want to address briefly is whether asset concentration limits should prevent mergers between large banking and non-banking institutions. The Proxmire-Garn proposal contains such limits (which would prevent mergers between the largest 15 domestic bank and securities firms); the Graham-Wirth bill does not.

To the extent that the motivation for asset concentration limits is political and social and not economic, economists have very little to say on the subject. My own personal view is that there is nothing inherently evil about the merger of large organizations. As long as they do not possess market power -- a prospect the antitrust laws are designed to prevent -- consumers are not threatened. And if financial organizations grow too large to be efficient, then market forces over time will whittle them down -- either their managers will divest inefficient operations or someone will take the companies over to force the same result.

Nevertheless, asset concentration limits may have a desirable result: they may encourage bank and securities houses to enter each other's businesses from scratch or by buying a smaller existing entrant, with the hope of building it larger. In either event, competition may be enhanced, which could benefit consumers.

In sum, I see no great downside from asset concentration limits as long as they are not unreasonable. I believe that the limits in the Proxmire-Garn bill pass this test.

ment toward nationwide interstate banking (for which the states are also responsible) is completed.

Given the national scope of financial activity, I believe consumers would be better off if the inevitable restructuring of the financial services industry were accomplished in a more orderly fashion and directed at the federal level instead. Three basic legal frameworks may be used: (1) permitting banks to conduct nonbanking activities directly or through wholly owned subsidiaries; (2) allowing financial product diversification to proceed only through holding company structures; and (3) permitting highly diversified organizations to engage in banking, but only through fully securitized "narrow banks." Under certain circumstances, any one of these frameworks would produce gains to society that outweigh the risks. However, I believe only the third option—narrow banking—best promises both to maximize net social benefits and to break the political stalemate at the federal level that has thus far thwarted efficient restructuring of the financial services industry.

Benefits of diversification

Society can benefit in three ways as financial service firms—and especially commercial banking and thrift organizations—become increasingly diversified.

- Certain nonbanking industries, notably investment banking, could use a strong dose of additional competition. Numerous academic studies have demonstrated that in securities markets where banks can underwrite, such as general obligation municipals, market concentration is lower, competition is more vigorous, and underwriting fees are lower than in the corporate securities markets from which banks are precluded (see Pugel and White, and Silber in For Further Reading). There is also every reason to believe that the megafees investment banks now charge for advising companies involved in mergers, and then blessing the "fair value" of the resulting transactions, would come down in a more competitive market.
- Financial institutions that diversify should be able to offer multiple services more cheaply than the aggregate costs of providing them through separate organizations. An institution that advertises and delivers bank services, for example, can also market and deliver securities, insurance, and real estate services at little or no extra cost. Economies of scope should also be realized in the combination of "backroom" operations. Banks, insurance companies, and other financial service companies are all essentially in the same business—providing and transferring information. Any financial corporation doing business today should be capable of using the computer-stored data that lie at the core of one financial service to deliver other services and thus lower the costs of providing them all.
- Just as individuals purchase mutual funds to spread the risks of their stock and bond holdings, banking organizations can benefit by offering services that help smooth out the earnings fluctuations of bank activities alone. Based on profit data reported to the Internal Revenue Service, I have calculated that over the 1965–82 period, the average bank organization could have achieved the same level of average earnings as it did, but with 45 percent less fluctuation (or variance), had bank holding companies been permitted to diversify into currently proscribed financial activities. These potential gains from portfolio diversifications are important because, if realized, they would benefit both banks and the agency that insures them, the FDIC.

Risks of diversification

Diversification by banks and other firms that want to engage in banking is not free of risk, however. At least four different risks merit attention by policymakers.

- Although it is generally the case that banking and thrift organizations could reduce their risk exposure by diversifying into other activities, a significant number of institutions could diversify in a risk-enhancing fashion. Managers of some institutions may deliberately seek greater risk, particularly in view of the incentives for risk-taking created by the current system of federal deposit insurance, which charges banks the same insurance premium regardless of their risk of failure. In addition, given their inexperience in other lines of business, certain depository organizations may find their diversification efforts to be less than successful. In fact, I have found that between 1978 and 1984 over a third (11 of 30) of the largest bank holding companies had more volatile earnings patterns than their subsidiary banks, a result indicating that many banking organizations have already increased their risks by taking advantage of their limited nonbanking powers.
- There is a long history of concern in this country that, left totally unconstrained, banking organizations will wield too much economic power—that is, asset ownership will become too concentrated. Critics of excessive asset concentration also fear its adverse ef-

fects on our democratic political system.

- As banking and thrift organizations gain broader product-line freedom, some institutions may abuse their new powers. In particular, while existing law largely prevents banks from channeling excessive funds to their affiliates, there is a risk that banks could aid their affiliates indirectly by favoring their *customers* in extending bank loans. At a minimum, this practice would abuse the deposit insurance system by giving nonbanking enterprises affiliated with banks an artificial advantage over their independent competitors. At worst, banks that relaxed their credit standards in channeling loans to customers of affiliates would be exposing themselves—and the FDIC—to enhanced risk of loss.
- Many in the Federal Reserve System are concerned that as banks become increasingly intertwined with other businesses, the payments system will be exposed to greater risk (see Corrigan, pp. 28-35 and in For Further Reading). Specifically, it is feared that through their affiliations with banks, nonbank enterprises will gain indirect (if not direct) access to the major payments networks—FedWire (operated and guaranteed by the Federal Reserve) and "CHIPs" (the major private funds-clearing network, which many believe the Fed would rescue in a crisis). If threatened with failure, it is conceivable that bank-affiliated enterprises would so overdraw their accounts at their sister banks as to threaten them and other banks relying on them for "good" funds with failure—forcing the Fed to lend the necessary funds to prevent a collapse of the payments network.

Given the inevitable blending of financial services, federal policymakers have a responsibility for creating the regulatory framework that best promises to maximize the benefits from diversification while limiting the risks. Three basic approaches are available for governing the transition to a fully competitive "level playing field."

Direct bank diversification

The first framework, recently endorsed by the staff at the FDIC (see For Further Reading), would permit banks to exercise broader powers directly or through separate subsidiaries. As suggested at the outset, this is the approach the nation will adopt *de facto* if Congress remains stalemated on the issue of bank powers, while the states continue to broaden the activity authority of their banks and thrifts.

The FDIC's staff report urges instead that Congress speed up this process by repealing the Bank Holding Company Act—which currently authorizes banking organizations to engage only in a restricted set of nonbanking activities "closely related to banking"—and then scheduling the "orderly" liberalization of nonbank activities that banks may pursue. Representative Thomas Carper (D-Del.), a member of the House Banking Committee, has recently proposed a legislative alternative intended to achieve the same objective. His bill, "The Dual Banking System Enhancement and Financial Service Competitiveness Act" (H.R. 3063), would give national banks the same activity rights as the state banks in the same states (see Table 1).

Permitting banks to diversify directly has some key advantages. It permits banks to realize any economies of scope and diversification benefits directly, without suffering the burdensome costs of forming and operating through holding companies.

But the "direct" approach also potentially allows banks to use insured deposits to subsidize entry into nonbank businesses. This not only gives nonbank operations owned or operated by banks an unfair advantage over independent competitors, but also poses a threat to the safety and soundness of the banking system itself. As already noted, the existing system of deposit insurance creates "moral hazard" incentives for banks to take risks. These incentives for risk-taking can infect banks' diversification decisions as they are permitted to broaden their business horizons.

The FDIC's staff report recognizes these dangers and outlines several ways to avoid them. It contends that potential abuses by banks can be nipped in the bud by aggressive bank supervision (presumably by the FDIC). It also suggests that bank investments in nonbank subsidiaries not be counted as part of a bank's required capital for regulatory purposes. In effect, this would require banks that diversify broadly to maintain larger capital cushions than other less diversified depositories. Finally, the report would require bank and nonbanking operations to have separate directors and officers.

These are all worthy suggestions. But several nagging questions remain. First, the FDIC's staff report does not address in detail which activities banks will be allowed to pursue directly and which through subsidiaries. The difference is important. Activities conducted inside a bank that run into difficulties directly threaten the solvency of that bank; those operated in subsidiaries only threaten the bank's equity investment in them, which under the FDIC staff's proposal would not be treated as part of bank capital for regulatory purposes.

Second, even bank investments in subsidiaries would benefit from a bank's access to deposit insurance. Firms in the securities, insurance, and real estate industries not now owned by banks must raise their capital in the markets without benefit of insurance. Bank-owned enterprises in these fields (and perhaps commercial businesses as well under the FDIC's proposed structure), in contrast, would be capitalized with insured depositors' funds.

Finally, the "direct" approach to bank product-line diversification relies heavily on strict supervision to insulate banks from any problems encountered in their nonbank operations. There are reasons for skepticism. Even with the most sophisticated of projection techniques, bank regulators currently are able to project only two-thirds of bank failures a year in advance (see Bovenzi in For Further Reading). Significantly, our bank regulatory system failed to catch Penn Square (of Oklahoma), Continental Illinois, and Seafirst (of Washington) before they failed. The current state of affairs leaves much to be desired. FDIC Chairman William Seidman recently acknowledged that his agency is "significantly behind in its examination schedule" (see Rehm in For Further Reading).

Regulators must assume that many banking organizations will, notwithstanding their legal right to walk away from their ailing nonbank operations, attempt to rescue them. Even with additional and perhaps better-paid examiners, it is not at all clear that the federal

Table 1

State Bank Powers Broader Than Those Permitted National Banks

(through March 1987)

	Securities			Real Estate		Insurance	
	Corporate securities underwriting	Equity investment	Full service brokerage	Development and/or equity participation	Brokerage	Underwriting	Agency
Alabama			X				X
Alaska				X			
Arizona		X		X	X		
Arkansas			X	X			X
California	X	X	X	X	X		
Colorado				X			X
Connecticut		X	X	X	X		
Florida	X	X	X	X	X	X	
Georgia			X				X
Hawaii							X
Idaho							X
Indiana							X
Iowa							X
Kansas							X
Kentucky				X			
Maine				X			
Maryland							X
Massachusetts	X	X	X	X	X	X	X
Minnesota							X
Missouri				X			X
Nebraska							X
Nevada				X			
New Hampshire		X		X			
New Jersey	X	X	X	X	X	X	X
New York	X		X	X			X
North Carolina	X	X	X	X	X	X	X
North Dakota							X
Ohio		X		X			
Rhode Island	X	X	X	X	X		
South Dakota				X		X	X
Tennessee				X			X
Texas	X						
Utah				X			
Vermont		X	X				
Virginia							X
Washington				X			X
Wisconsin							X
Wyoming							X

Note. Powers shown in the table include those authorized for state-chartered banks directly and those permited only to subsidiaries of state-chartered banks.

Source: Victor Saulsburg, "State Banking Powers: Where Are We Now?" *FDIC Regulatory Review*, April/March 1987, pp. 1-16.

bank regulatory agencies can prevent the downfall of one or more major banks caused by nonbank operations that turn sour.

Diversification through holding companies

Given some of the pitfalls of direct bank diversification, most of those advocating financial restructuring have proposed that new nonbank activities not now operated by banks be conducted out of separate affiliates belonging to a common holding company. For example, the Reagan Administration in 1983 and E. Gerald Corrigan (President of the Federal Reserve Bank of New York) in 1987 proposed, in essence, that bank holding companies be permitted to engage in any "financial" activity (although the Administration's proposal excluded corporate securities underwriting). The Association of Bank Holding Companies and others, meanwhile, have suggested the creation of new "financial service" holding companies, which could own existing bank holding companies with their limited powers, as well as other financial (and conceivably even commercial) enterprises.

Like the direct bank diversification framework, however, the holding company structure also would be supplemented with additional restrictions largely to insulate the bank from problem affiliates, but also to limit risks to the payments system and to prevent tie-ins and conflicts of interest. Although the various holding company plans differ, a number of restrictions are commonly mentioned:

—Extending to new affiliates the provisions of Sections 23A and 23B of the Federal Reserve Act, which now limit funds transfers from banks to any one of their holding company affiliates to no more than 10 percent of bank capital (23A) and require that all inter-affiliate transactions be on "at-arms'-length" terms (23B);

—Including intraday overdrafts by nonbanking firms on their affiliated banks within the funds transfer limits of Section 23A;

—Requiring nonbank affiliates to disclose to investors that the affiliate's obligations are not deposits and thus not covered by federal deposit insurance;

—Requiring banks in highly diversified organizations to maintain additional capital and/or to be divested from these organizations if their capital falls below a minimum threshold level (above 0).

All of the holding company plans propose that each of the subsidiaries continue to be regulated by their primary regulators (e.g., the SEC in the case of securities subsidiaries, state insurance commissions for insurance subsidiaries, etc.). However, they differ on the residual regulatory authority of the Federal Reserve. Under the Corrigan proposal, the Federal Reserve would maintain "a degree" of supervision over the entire organization. Most of the other proposals would eliminate any regulatory role for the Fed. Instead, the bank's primary federal regulator (either the FDIC or the Comptroller) would be responsible for monitoring the soundness of the bank and its compliance with the relevant interaffiliate restrictions.

At bottom, the success of both the holding company approach and the direct bank diversification option hinges largely on the ability of regulators to prevent abuses by diversified organizations that threaten the soundness of their banks. The pressure on regulators will be most intense when nonbank affiliates are in financial difficulty. As Walter Wriston (former chairman of Citicorp) stated in 1981 in a now infamous remark, "It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world" (see Wriston in For Further Reading).

Advocates of the holding company approach argue that the strict limitations of Section 23A on bank-to-affiliate funds transfers can prevent the so-called "Wriston problem." But managers of bank holding companies can find other ways to prop up affiliates at the expense of their banks. They can cleverly allocate overhead and/or price services provided by the holding company in ways that favor the nonbank subsidiaries. More significant, banks can channel loans to customers of affiliates in efforts to entice customers to use the affiliates' services.

In theory, a "bear-down" requirement that forced a bank's divestiture from its holding company if bank capital fell below some minimum level would provide the best safeguard against attempts by managers of diversified financial organizations to plunder their banks (and potentially the FDIC) in efforts to bail out troubled affiliates. But, in practice, even the bear-down option has weaknesses. As already noted, regulators simply may not be able to catch serious problems in time. And even if they can, divestiture is the banking equivalent of a nuclear bomb. Although a target bank's capital for regulatory purposes may be positive (but below the threshold minimum), by forcing divestiture, regulators signal to potential buyers that the bank may have serious problems, which can dramatically lower its resale value. Moreover, it would be especially difficult to implement a "bear-down" requirement if banks were permitted to diversify directly or through subsidiaries. In that event, if bank capital fell below the required minimum, regulators could separate the bank only by selling off each of the nonbank activities—an operation potentially far more difficult and disruptive to complete than merely divesting a bank from its holding company affiliates.

The holding company option has two additional problems. One is the danger that bank depositors will run if nonbank affiliates are threatened (the same danger is posed by the direct bank diversification option as well). However irrational this behavior may look, it happened in 1973 when a mortgage banking affiliate of a bank in Beverly Hills, California failed. The risks of it happening again are, if anything, likely to grow as the nation moves toward the "Brave New World" of financial product deregulation.

Second, advocates of the holding company approach have thus far, in my view, paid too little attention to how Congress would actually implement it. Specifically, if and when opponents of expanded bank powers recognize that they are on the losing side of the debate, they will almost certainly switch tactics by urging that Congress enact a "telephone book" of statutory rules and restrictions designed to wall off totally the bank from its nonbank affiliates. The first entry in this telephone book (among others more onerous than the supplemental restrictions listed above) is likely to be a prohibition on the cross-marketing of services and products offered by a bank and its nonbanking affiliates. Indeed, the 1987 Competitive Equality in Banking Act contains provisions of this type. Clearly, if diversified organizations cannot jointly market the services of all their subsidiaries, they would be unable to offer a "grocery store" of financial services—the model that provides the major rationale for restructuring the financial services industry.

The "narrow bank" alternative

There is a way to avoid the "telephone book" problem while addressing each of the major risks of broadening the powers of organizations engaged in banking. It lies in dusting off the "100 percent reserve banking" proposal advanced many years ago by Irving Fisher and Henry Simons (and more recently by Milton Friedman)—which urged that all bank deposits be invested in interest-bearing accounts at the Federal Reserve—and adapting it to our modern financial structure. Recently, several experts on the financial services industry—including Hans Angermuller, Alton Gilbert, Carter Golembe, John Karaken, and John Mingo—have advocated such an approach.

In brief, I suggest that Congress create a new *voluntary* option for firms that own or wish to own an insured depository (bank or thrift) *and* also to engage in an unrestricted set of nonbanking activities, financial or commercial, beyond those currently allowed for bank holding companies. In exchange for broader powers, these highly diversified organizations would have to confine the activities of their insured institution solely to accepting deposits (of any maturity) and investing the proceeds in safe, liquid securities—such as Treasury securities or instruments guaranteed by the federal government or by a quasi-federal agency (i.e., the Federal National Mortgage Association). Significantly, these "narrow banks" could not make loans. Instead, the diversified conglomerates would conduct any lending out of separate affiliates, funded by uninsured liabilities (primarily commercial paper) and equity—just as such large commercial lenders as General Electric Credit Corp. and Commercial Credit Corp. are funded today. None of the nonbanking subsidiaries or their parent companies would have access to the payments system because none would be permitted to hold deposit accounts at their narrow banks. However, no restrictions would be placed on the cross-marketing of services by these diversified supermarkets, or on the use of common names, officers, directors, or places of location.

Before turning to a number of the practical details of how such a framework might be implemented, it is instructive to see how this simple approach—splitting deposit-taking from lending—would address the major concerns that have been raised about financial product deregulation.

First, narrow banking directly addresses concerns about bank safety and soundness. Narrow banks could not extend loans and therefore could not be used to prop up ailing affiliates (either by lending to them or their customers). Even if the failure of a nonbank affiliate induced depositors at the narrow bank to "run," the bank could meet the run because it would be fully "securitized."

Second, the separation of deposit-taking and lending would go a long way toward addressing concerns about undue concentration of ownership and conflicts of interest. Both concerns are based primarily on fears arising out of the significant role that banks play in the allocation of credit. But if narrow banks belonging to diversified conglomerates could not make loans, these fears should be allayed.

Third, narrow banking removes the need for a telephone book of restrictions aimed at preventing potential conflicts, tie-ins, and other abuses. In the process, it directly undercuts the most successful argument opponents of broader bank powers have raised thus far—that because banks have access to deposit insurance, they or their holding companies would gain unfair advantage over independent enterprises if bank activity restrictions were lifted. Narrow banks would continue to be eligible for deposit insurance (although at lower premium rates to reflect their lower risk); however, because they would be limited to investing only in safe securities, they would not be able to exploit their access to deposit insurance in their affiliations with other firms.

Since I first began to discuss the narrow bank option, I have received a number of comments, questions, and criticisms. Several of these are worth addressing here:

- *Would the separation requirements apply to banking organizations immediately?* No. Requiring large banking organizations suddenly to transfer their existing loan portfolio to separate lending affiliates, funded entirely by commercial paper, long-term debt, and equity, would simply place too much pressure on the securities markets. Instead, existing bank holding companies that wish to exercise broader powers immediately would be required to complete the transfer gradually over a ten-year period (10 percent of current loan assets transferred each year).

- *Would there be a sufficient volume of securities available to permit organizations to form narrow banks?* The current volume of privately held Treasury securities and instruments guaranteed by the federal government is in excess of $1.5 trillion. This figure is roughly twice the total of all loans currently held by the top 35 bank holding companies combined (many of whom would not convert, or be able to convert, their conventional banks to narrow banks).

- *Would the separation requirement of the narrow bank proposal apply to all banks?* No. Small banks and thrifts (say with deposits below $50 or $100 million), which for all practical purposes would be unable through their lending affiliates to fund their loans with commercial paper, would be exempted from the separation requirements. That is, if the states want to give their smaller institutions broader powers, they would be permitted to do so without requiring these institutions to reorganize as narrow banks. Policymakers should be concerned primarily about the effects of product-line diversification by larger banking organizations, whose failure could pose a threat to the financial system as a whole in a way that the failure of smaller banks does not.

- *Would the narrow bank option adversely affect the ability of the Federal Reserve to control the money supply?* No. Narrow banks would be subject to the same reserve requirement as conventional banks. Accordingly, the "money multiplier" would remain unchanged.

- *Would the narrow bank proposal significantly increase interest rates?* No, but some increase might occur because more lending would be extended through firms funded from uninsured sources. At most, however, interest rates would increase on the order of 50 basis points, the recent differential between interest rates on commercial paper and "jumbo" insured certificates of deposit. But, in fact, even this differential probably overstates the extent of any increase in lending rates because the lending affiliates would not be subject to reserve requirements, deposit insurance premia, and other regulatory restrictions that would continue to apply to conventional banks.

- *Why would banking organizations be interested in narrow banking?* Many bankers claim they could not make money on a narrow bank because they would be restricted to investing in lower yielding (but safer) assets than conventional banks. This may be true, but it does not mean that the option would be unprofitable. Narrow banking is simply the price that diversified organizations would have to pay to be able to offer the *grocery store* of services (financial and nonfinancial) that many firms (such as Sears, American Express, and others) claim is a profitable business. For highly diversified firms, depository services would provide an anchor for marketing a cluster of other services. Many bank holding companies may nevertheless continue to believe that they couldn't make money with a narrow bank. But why not create the option and let the market determine who is right?

- *Would narrow banking lead to a more unstable financial system?* Perhaps the most commonly voiced concern about narrow banking is that it would channel an increasing volume of lending in the economy through uninsured lending institutions and thereby expose the financial system to a greater risk of collapse. Specifically, it is feared that if a large lending affiliate funded largely by commercial paper were threatened with failure, investors could run from the commercial paper market generally unless the Federal Reserve came to the rescue by exercising its lender-of-last-resort powers.

I believe this concern is overstated for at least three reasons. First, only the least risky banking organizations would even be able to take advantage of the narrow bank option because only they would have loan portfolios sufficiently high in quality to be funded by commercial paper. Second, precisely because their liabilities are uninsured, the lending affiliates of narrow banks would have higher capital ratios than conventional banks. Indeed, large commercial finance companies today typically have capital-to-asset ratios in the neighborhood of 13 percent, roughly twice the ratios maintained by banks, as a recent Federal Reserve Bank of New York staff study showed.

Finally, unlike the early 1970s when the bankruptcy of Penn Central evoked concerns about a run on a thin commercial paper market, the commercial paper market today is highly developed (with over $400 billion in outstanding securities) and very liquid. Just as the municipal bond market did not collapse when the Washington State public power authority bonds went into default, neither should policymakers fear that the entire commercial paper market would come tumbling down if a major commercial lender (say, GE Credit) were to fail.

The recent interest in developing frameworks for governing the financial services industry of the future is healthy. It signals growing recognition by policymakers of the need to design a regulatory structure that maximizes benefits to consumers, while limiting the risks to the financial system as a whole. If recent trends continue, however, our new regulatory structure will not emerge from deliberate consideration by federal lawmakers, but as an outgrowth of legislation in each of the 50 states instead. There is a better way. But we are running out of time.

The CHAIRMAN. Thank you very much, Mr. Litan.
Mr. Haraf.

STATEMENT OF WILLIAM S. HARAF, J.E. LUNDY, SCHOLAR AND DIRECTOR, FINANCIAL MARKETS REGULATION PROJECT, THE AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. HARAF. Mr. Chairman and members of the committee, it is an honor to testify before this committee on S. 1886 and S. 1891.

Financial modernization is a subject of great importance. The future prosperity of our Nation depends on an efficient, competitive, stable financial system.

Our laws and regulations need updating. The present system has limited competition, raised costs, forced financial activity overseas, distorted the allocation of capital, and shifted costs and risks to taxpayers. As technology and the competitive environment have changed, these problems have become more pronounced.

FINANCIAL INTEGRATION

A number of proposals for financial restructuring are now on the table. A common element among them is greater integration of banking with other services in a common corporate structure. A broad consensus has emerged that greater financial integration would be beneficial, but there are significant differences as well. How much integration is desirable? Should banking be separate from commerce? Is consolidated supervision at the holding company level necessary?

The American Enterprise Institute recently completed a major research program in financial regulation. The project involved the collaborative efforts of 14 leading banking and finance scholars. Attached to my testimony is a list of the component studies and their authors, as well as executive summaries of these reports.

The outcome of our research is not an "AEI plan" for financial restructuring in the same sense as there is a "Corrigan plan" or a "Financial Services Council plan". Instead, we have developed a generally coherent body of analysis and a set of policy conclusions and recommendations derived from that analysis that we hope can be useful as a standard for judging the range of proposals now under consideration.

My comments today on these bills draw heavily upon this research.

With respect to S. 1886, I view this as a very useful first step toward a more efficient financial system. It contains elements I believe can be improved upon, but on balance it would be important and beneficial legislation.

In hearings spanning the terms of two chairmen, this committee has heard numerous witnesses testify as to the considerable benefits of breaking down Glass-Steagall barriers. There is little I can add to this testimony.

S. 1886 would limit the ability that some suppliers now have to exercise market power. It would provide producers with incentives to become more efficient. It would provide consumers the advantages of purchasing combinations of services from a single supplier. It would add liquidity to secondary markets for many securities.

The bottom line is lower cost and better quality financial services for individuals, businesses of all sizes, and State and local governments.

I would like to emphasize that this is not just an issue affecting our largest banks and securities firms. Over time community and regional banking organizations will become active participants as well in ways that benefit consumers and local communities.

Now, let me say a few words about aspects of this bill that I believe can be improved; first, with respect to the insulation provisions.

The insulation provisions are motivated by concerns over safety and soundness and competitive abuses. Public policy must balance these concerns against the social costs of regulations designed to address them. It is possible to have too much insulation as well as too little.

Our objective should not be to devise a framework in which no bank or thrift ever fails due to activities of its affiliates, or in which no competitive abuses ever occur. A balance must be struck between achieving adequate insulation and permitting desirable synergies.

As you know, present laws already provide substantial insulation. They seem to work pretty well. In particular, I am not aware of any evidence that bank holding companies with foreign securities subsidiaries have run into trouble from intracompany transactions.

I am attracted to the approach taken by the bill introduced by Senators Cranston and D'Amato yesterday. It retains existing restrictions, and it authorizes the bank's primary regulator to promulgate additional rules as necessary. This approach gives regulators some flexibility to adapt insulation provisions as experience is gained and so as conditions change.

The bill also contains some very important new safeguards. It would require divestiture of a depository institution if minimum capital standards are not maintained. It would also allow regulators to force divestiture if a firm is engaged in conduct that would endanger safety and soundness of the depository firm. I am not a lawyer, but I believe that these divestiture provisions can be enforced in a timely way.

In our study of deposit insurance reform, the AEI project concluded that the best way to protect the deposit insurance fund from excessive losses is through timely reorganization of the capital of their banks and thrifts. I view these divestiture requirements as being consistent with that approach. They would lead to less frequent and less costly interventions by the deposit insurance agencies.

The bill also provides regulators with a number of new enforcement tools, including greater injunctive powers and high monetary penalties on both companies and individuals. I believe an approach focusing on enforcement powers and penalties is preferable to one based on sweeping restrictions on transactions.

As to the concentration limits in the bill, I agree with Mr. Gould and Bob Litan. The real issue is the abuse of market power. Abuses may occur by very large firms or by very small firms, depending upon the market environment in which they operate. Limitations on size per se distract attention from the true problem, which is barriers to entry. If barriers to entry are removed, competition will increase, and abuses of market power will be less likely.

The present regulatory standards and antitrust laws provide sufficient safeguards against mergers that would restrain competition. I do not see any reason to have a separate policy applicable to banks and securities firms.

Now, with respect to S. 1891——

Senator **Chafee**. Mr. Chairman, I wonder if I might interrupt for 1 minute.

Unfortunately, in the Finance Committee we are trying to do what we can now to comply. We are attempting to comply in the Finance Committee with the agreement that was reached. So I will be unable to stay.

I just do want to congratulate you and Senator Garn for what you are doing here. I wish I could stay. I will go over the statements.

Senator **Riegle**. Would the Senator yield?

He and I are in the same situation, both on the Finance Committee, and we are on a very short deadline here, and I very much want to be up here this morning. Unfortunately, you can't be two places at the same time.

So I will read your testimony carefully. I am sorry I can't be here in person as well.

Thank you.

The **Chairman**. Thank you, Senator Chafee, Senator Riegle. We appreciate that very much.

Pardon us, Mr. Haraf. Go ahead.

S. 1891 IS NOT THE RIGHT APPROACH

Mr. **Haraf**. While I view S. 1886 as an important and beneficial first step to financial restructuring, I do not believe that S. 1891 is the right approach to comprehensive regulatory reform. Although this bill goes further in terms of integrating banking with the rest of finance, it does so in a way that I believe would be detrimental to the financial system in the long run.

I believe that with proper insulating safeguards in place, there is no need to restrict the activities of organizations with banking subsidiaries. There is no need for a super-regulator, be it the Federal Reserve or a new Financial Services Oversight Commission. There is no need for capital requirements at the holding company level and, most importantly, there is no need to extend the safety net to a broader class of firms, as this plan does.

This bill, which implements the so-called Corrigan plan, would extend the reach of activity regulation and the safety net to nonbank financial firms. According to Mr. Corrigan, "A Federal safety net surrounding banking and finance is both appropriate and necessary."

I disagree. Over the past decade, the financial safety net has been extended, sometimes in obvious ways, sometimes in subtle ways, through a range of insurance, credit, and contingent credit programs. In the process, more and more financial risk has been shifted to taxpayers. Our experience with these programs has not been good. One only needs to consider the FSLIC debacle, the Continental bailout, the bankruptcy of the Farm Credit System, and looming problems with the PBGC to realize the potential problems and costs involved.

Granting broader access to the discount window and to the FedWire is likely to encourage some forms of risk-taking, lead to the erosion of private arrangements for liquidity, and discourage the private provision of payments services.

Under this proposal, an oversight regulator would be charged with the responsibility for maintaining a separation between finance and commerce. The line between commercial and financial activities however, can be fuzzy. Let me give you one example.

Financial services firms are largely information managers, collecting, storing, and communicating information. Their information management systems are a key to their competitiveness. These systems may have broad applicability to commercial as well as financial firms. Would developing and marketing information management systems for commercial firms be prohibited under this plan? Is it sound public policy to prohibit such activity?

The AEI studies concluded that depository institutions should be allowed to freely affiliate with other firms, including those engaged in commercial activities. So long as insulating safeguards are in place, it is best to let the market determine the activities that can be profitably conducted within a single organization.

Finally, with respect to payment system provisions, the payments system does need reexamination. Participants in the electronic transfer systems are exposed to substantial credit risk as a result of current payments practices. This includes the Federal Reserve, which provides guarantees and interest free credit in connection with payments made over FedWire.

This bill manages payments system risks through a National Electronics Payments Corp. Suffice it to say here that there are a variety of less costly and more direct solutions to the problems of risk in the payments system than this proposal offers.

In conclusion, the main threat to safety and soundness and the deposit insurance funds is not greater integration of banking with other services, but the continued operation of a large number of troubled banks and thrifts with little or no economic capital.

The more regulators rely on meaningful capital standards and prompt reorganization of capital-impaired depository firms, the less regulation is needed to protect the deposit insurance funds.

Thank you.

[The complete prepared statement of William S. Haraf follows:]

Statement of

William S. Haraf

J.E. Lundy Scholar and Director,
Financial Markets Regulation Project

The American Enterprise Institute
for Public Policy Research

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

December 2, 1987

Mr. Chairman and members of the committee, it is an honor to testify concerning S.1886, The Financial Modernization Act of 1987, and S.1891, The Financial Services Oversight Act. Financial modernization is a subject of great importance. The future prosperity of our nation depends on an efficient, competitive, and stable financial system.

Our laws and regulations governing financial activities need updating. The present system has limited competition, raised the cost of financial services, forced financial activity overseas, distorted the allocation of capital, and shifted costs and risks to taxpayers. As technology and the competitive environment have changed, these problems have become more pronounced.

A number of proposals for restructuring financial regulation are now on the table. A common element of these proposals is greater integration of banking with other services within a common corporate structure. A broad consensus has emerged that greater financial integration would be beneficial. But there are significant differences as well. How much integration is desirable? Should banking be separated from commerce? Is consolidated supervision at the holding company level necessary?

The American Enterprise Institute recently completed a major research project in financial regulation. The project involved the collaborative efforts of fourteen leading banking and finance scholars. Attached to my testimony is a list of the component studies and their authors, as well as executive summaries of these reports.

The outcome of our research is not an "AEI plan" for financial restructuring in the same sense as there is a "Corrigan plan" or a "Financial Services Council plan." That was not our objective. Instead, we have developed a generally coherent body of analysis, and a set of policy conclusions and recommendations derived from that analysis, that we hope can be useful as a standard for judging the range of proposals now under consideration.

The AEI project provides a framework for answering the questions about financial restructuring I raised earlier. The project also considers other urgent issues, such as deposit insurance reform, protection of the payments system, the role of Federal Reserve regulations in the conduct of monetary policy, international coordination of regulation, the federal government's role in the housing finance system, and the design of the regulatory structure.

My comments today on the bills that are the subject of this hearing draw heavily upon this research.

S.1886, THE FINANCIAL MODERNIZATION ACT OF 1987.

I view S.1886 as a very useful first step toward a more efficient financial system. It contains elements I believe can be improved upon, but on balance it would be important and beneficial legislation.

In hearings spanning the terms of two chairmen, this committee has heard numerous witnesses testify as to the considerable benefits of breaking down Glass-Steagall barriers. There is little I can add to this testimony.

S.1886 would limit the ability some suppliers now have to exercise market power. It would provide new opportunities to achieve economies from joint production, distribution, and information management. It would provide consumers of financial services the advantages of purchasing combinations of services from a single supplier that are now available only from separate suppliers. It would add liquidity to secondary markets for many securities.

The bottom line is lower cost and better quality financial services for individuals, businesses of all sizes, and state and local governments.

I would like to emphasize that this is not just an issue affecting our largest banks and securities firms. Over time, community and regional banking organizations would become active participants in securities markets as well. Banks of all size ranges can be expected to compete in the municipal revenue bond market, the market for asset-backed securities, and as sponsors of mutual funds in ways that benefit consumers and local communities.

Now let me say a few words about aspects of the bill I believe can be improved.

Insulation Provisions.

The requirement that securities and banking activities be conducted in separately capitalized, well-insulated affiliates in a holding company structure is motivated by concerns over safety and soundness and competitive abuses. Public policy must balance these concerns against the social cost of regulations designed to address them. It is possible to have too much insulation as well as too little.

Our objective should not be to devise a framework in which no bank or thrift ever fails due to activities of its affiliates, or in which no competitive abuses ever occur. A balance must be struck between achieving adequate insulation from risks posed by affiliates, while permitting desirable synergies in the joint production, distribution, and marketing of financial services.

Present laws already provide substantial insulation. They seem to work well. In particular, I am not aware of any evidence that bank holding companies with foreign securities subsidiaries have run into trouble from intracompany transactions.

I am attracted to the approach taken by the Financial Services Council in a bill introduced yesterday by Senators Cranston and D'Amato, "The Depository Institution Affiliation Act." It retains existing restrictions, such as those imposed by Sections 23A and 23B, and authorizes a bank's primary regulator to promulgate additional rules as necessary. This approach gives regulators some flexibility to adapt insulation provisions to changing conditions.

The bill also contains some very important new safeguards. It would require divestiture of a depository institution if minimum capital standards are not maintained. It also would allow regulators to force divestiture if a depository institution, or any of its affiliates, is engaged in conduct that would endanger safety and soundness of the depository.

In our study of deposit insurance reform, the AEI project concluded that the best way to protect the deposit insurance funds from excessive losses is through timely reorganization of capital-impaired banks and thrifts. I view these divestiture requirements as being consistent with that approach. They would lead to less frequent and less costly interventions by the deposit insurance agencies.

The bill also provides regulators with a number of new enforcement tools short of divestiture, including greater injunctive powers and very high monetary penalties on both companies and individuals. I believe an approach focusing on enforcement powers and penalties is preferable to one based on sweeping restrictions on transactions.

Concentration Provisions.

As to the concentration limits in the bill, the real issue is the abuse of market power. Abuses may occur by very large firms, or by very small firms depending on the market environment in which they operate. In my view, limitations on size, per se, distract attention from the true problem, which is barriers to entry. As barriers to entry are removed by legislation and market innovation, competition will increase and abuses of market power will be less likely.

Present regulatory standards and antitrust laws provide sufficient safeguards against mergers that would restrain competition. I do not see any reason to have a separate policy applicable to banks and securities firms that is different from the laws applying to other firms.

Thrift exemption from S.1886.

I know this committee is deeply concerned about the threat insolvent thrifts pose to taxpayers. Allowing the Federal Home Loan Bank Board the freedom to permit thrift holding companies to engage in securities activities under its own, presumably less restrictive, rules will allow it to enhance the franchise value of insolvent thrifts relative to a bank charter. This seems to me a subtle way of making commercial bankers pay for the past mistakes and abuses of the thrift industry and its regulators. If an objective of this bill is, indeed, to make bankers pay, there are better ways to do it. Our history of providing preferential treatment for thrifts has not, on balance, produced good results for our financial system.

S.1891, THE FINANCIAL SERVICES OVERSIGHT ACT.

While I would view S.1886 as an important and beneficial first step to financial restructuring, I do not believe that S.1891 is the right approach to comprehensive regulatory reform. Although this bill goes further in terms of integrating banking with the rest of finance, it does so in a way that I believe will be detrimental to the financial system in the long-run.

I believe that with proper insulating safeguards in place, such as those contained in S.1886 or the Financial Services Council plan, there is no need to restrict the activities of organizations with banking subsidiaries. There is no need for a "super-regulator," be it the Federal Reserve, or a new "Financial Services Oversight Commission." There is no need for capital requirements at the holding company level. Most importantly, there is no need to extend the safety-net to a broader class of firms, as this plan does.

This bill, which implements the "Corrigan Plan," would extend the reach of activity regulation and the safety-net to nonbank financial firms. According to Mr. Corrigan, "a federal safety-net surrounding banking and finance is both appropriate and necessary." (underlining added) I disagree.

Over the past decade the financial safety-net has been extended, sometimes in obvious ways, sometimes in subtle ways, through a range of insurance, credit, and contingent credit programs. In the process, more and more financial risk has been shifted to taxpayers. Our experience with these programs has not been good. One only needs to consider the FSLIC debacle, the Continental bailout, the bankruptcy of the Farm Credit System, and looming problems with the PBGC to realize the potential costs involved.

Moreover, granting broader access to the discount window and to Fedwire is likely to encourage some forms of risk-taking, lead to the erosion of private arrangements for liquidity, and discourage the private provision of payments services.

The Separation of Finance and Commerce.

Under this proposal, an oversight regulator would be charged with the responsibility for maintaining a separation between finance and commerce.

The line between commercial and financial activities can be fuzzy. Let me give one example. Financial services firms are largely information processors, collecting, storing, and communicating information. Their information management systems are a key to their competitiveness. Financial services firms often develop their systems internally. Once developed, it may make sense to sell them to other firms. Such systems could plausibly have broad applicability to a wide range of commercial, as well as financial firms. Would developing and marketing information management systems to commercial firms be prohibited under this plan? Is it sound public policy to prohibit such activity?

The AEI studies concluded that depository institutions should be allowed to freely affiliate with other firms, including those engaged in commercial activities. So long as insulating safeguards are in place, it is best to let the market determine the activities that can be profitably conducted within a single organization.

Payments System Provisions.

The payments system needs reexamination. Participants in the electronic transfer systems are exposed to substantial credit risk during the day as a result of current payments practices. This includes the Federal Reserve, which provides guarantees and interest free credit in connection with payments made over FedWire.

This bill would manage payments system risks through a "National Electronic Payments Corporation," jointly owned by the Federal Reserve and private participants, but managed by the Federal Reserve. Suffice it to say here that there are a variety of less costly and more direct solutions to the problem of risks in the payments system than this proposal offers. Under present arrangements, the incentives of participants to limit daytime credit exposures remain small. Correcting these incentive problems, and making other relatively minor regulatory changes could reduce payments system risks to tolerable levels.

CONCLUSION.

In conclusion, the main threat to safety and soundness and the deposit insurance funds is not broader powers for banking organizations, but the continued operation of a large number of troubled banks and thrifts with little or no economic capital of their own at stake.

The more regulators rely on meaningful capital standards and prompt reorganization of capital-impaired depository firms, the less regulation is needed to protect the deposit insurance funds. Greater freedom from regulation will, in turn, contribute to a more efficient, adaptable, and safe financial system.

The main message of the AEI project is that the goal of a safe, efficient, and fair financial system is best achieved with regulations that are less intrusive to the functioning of free markets.

RESTRUCTURING THE FINANCIAL SYSTEM

Component Studies

I. Haraf, William S. and Kushmeider, Rose Marie. "Redefining Financial Markets."

II. Benston, George J. and Kaufman, George G. "Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options."

III. Schwartz, Anna J. "Financial Stability and the Federal Safety Net."

IV. Goodfriend, Marvin and King, Robert G. "Financial Deregulation, Monetary Policy, and Central Banking."

V. Flannery, Mark J. "Payments System Risk and Public Policy."

VI. Weicher, John C. "The Future Structure of the Housing Finance System."

VII. Folkerts-Landau, David and Mathieson, Donald J. "The Process of Innovation, Institutiional Change and Regulatory Response in International Financial Markets."

VIII. Saunders, Anthony. "Bank Holding Companies: Structure, Performance and Reform."

IX. Edwards, Franklin R. "The Future Financial Structure: Fears and Policies."

X. Kane, Edward J. "How Market Forces Influence the Structure of Financial Regulation."

XI. Haraf, William S. "Restructuring Financial Services Regulation: Policy Recommendations of the AEI Study."

Executive Summaries

Restructuring The Financial System

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of the Papers Presented at the Conference

RESTRUCTURING THE FINANCIAL SYSTEM

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William S. Haraf

Introduction to the Financial Services Project

William S. Haraf
American Enterprise Institute

Over the past decade, financial markets have been changing at a pace not seen since the 1930s as a result of more volatile economic conditions, major technological and market innovations, the opening of capital markets worldwide, and legislation. New financial services and new methods of delivery have emerged, and the relative importance of established services and suppliers has shifted. Increasingly, commercial banks, thrifts, securities firms, and insurance and finance companies are competing for the same business in a global market for financial services. Yet the range of services firms can provide, where they can provide them, and on what terms, still depends importantly on the legal and regulatory framework under which they operate. The incidence, effectiveness, and costs of financial regulation fall unevenly on financial firms within the U.S. and around the world.

Some of our laws and regulations have produced inefficiencies and reduced consumer benefits. They have limited competition, prevented economies of scale and scope from being realized, and impeded an efficient allocation of capital. As technology and the competitive environment have changed, these effects have become more pronounced. Significant public benefits in the form of lower costs, higher returns, greater convenience, and a broader range of choices, have been lost as a result. Moreover, the rapid pace of change in financial markets has also been accompanied by greater financial strains. Record numbers of problem and failed banks, the bankruptcy of the FSLIC fund and the mounting burden of insolvent savings and loans it has yet to address, have raised serious concerns over the regulatory system's ability to accomplish its most essential function, that of preserving the stability and integrity of the financial system. The federal financial safety-net is badly in need of an overhaul to make it compatible with today's more competitive and open financial environment.

Over the years, state and federal legislation and changes in regulatory policy have been introduced piecemeal, in reaction to events and market forces. It is now clear that financial regulation is critically in need of fundamental restructuring. Changes are being debated that potentially could reshape the U.S. financial system for decades to come. The public has a major stake in the outcome. The challenge is to devise a market and regulatory framework that fosters competition and encourages efficiency, while safeguarding financial stability.

The American Enterprise Institute has undertaken a major research program to study financial services regulation in order to develop a comprehensive approach to reform. From the outset, the project was intended to explore ways to provide greater scope for competition and innovation while safeguarding financial stability and meeting other legitimate public policy concerns. Consisting of ten component studies and the work of fourteen scholars, the AEI project addresses the crucial issues that have been raised in the debate over how the U.S. financial regulatory system should be restructured. Because financial regulatory issues are fundamentally interrelated, the scholars met regularly over the course of a fourteen month period to develop a consistent and coherent approach to the issues. A brief description of the research studies follows.

Major Issues Addressed by the Research Studies

There is broad agreement on the major forces that have contributed to the rapid pace of change in the financial system: greater volatility of economic conditions and financial asset prices, significant advances in technology and in our understanding of financial markets, increased interdependence among nations, and regulatory changes. The introductory chapter to the project, "Redefining Financial Markets," coauthored by myself and Rose Kushmeider, examines the effects of these changes on financial markets, the problems posed by existing regulation, and issues regarding the appropriate direction for regulatory reform.

Deeply rooted problems with the deposit insurance system are at the core of many concerns with the present regulatory system. In recent years, failure resolution policies, regulatory forbearance, and explicit extensions of coverage have expanded the level of deposit insurance protection. As a result, market disciplines have eroded, exacerbating the perverse incentives inherent in the system. In "Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options," George Benston and George Kaufman critically examine the key problems with the present system and develop specific recommendations for improving the functioning of the deposit insurance system.

Responsibility for maintaining financial stability in the U.S. is shared between the deposit insurance agencies and the Federal Reserve in its role as lender of last resort and ultimate supplier of liquidity to the financial system. Indeed, deposit insurance was established in 1933 only after the central bank failed to effectively contain the financial crisis associated with the great depression. In today's markets, however, the proliferation of new financial instruments, the ability to rapidly transfer funds across national borders, and the reduced role of traditional financial intermediation have increased the importance of sound central bank policies. In "Financial Stability and the Federal Safety-Net," Anna Schwartz examines the respective roles of deposit insurance and the central bank, focusing on the latter. She reviews the historic causes and consequences of financial crises in the U.S. and abroad to draw lessons for future central bank policy.

A major focus of the AEI project is the effect of regulation on efficiency, competition, and innovation in the financial industry. In "The Future Financial Structure: Fears and Policies," Franklin Edwards examines arguments against removing restrictions on geographic and product diversification. Would this lead to greater or less competition? Would consumers benefit, or would abuses become more likely? He evaluates such concerns as the potential for unfair competitive practices, conflicts of interest, safety and soundness, and concentrations of political power and examines how best to address them.

Depository firms have been uniquely subject to restrictions on corporate ownership and affiliations that have impeded the integration of banking with other financial and nonfinancial services. The potential benefits from integration in the form of synergies to producers and consumers could be substantial, but significant concerns have also been expressed. Are blanket prohibitions on affiliations necessary, or can regulations insulate depository firms from such concerns, while preserving opportunities for synergies? In "Bank Holding Companies: Structure, Performance, and Reform," Anthony Saunders examines the major issues posed by affiliations between depository firms and other financial and commercial enterprises, including protecting the payments system, minimizing conflict of interest abuses, and containing implicit subsidies from safety-net policies.

The system for making payments in the U.S. has been evolving rapidly in recent years. A surging volume of payments, especially over the electronic transfer systems, has raised new concerns. The Federal Reserve and users of private electronic transfer systems are exposed to substantial credit risk during the day as a result of current payments practices. Concern over these exposures has led to a wide range of proposed changes and has been used to justify restrictions on bank ownership by corporations. Mark Flannery evaluates these arguments and proposals and makes specific policy recommendations for managing electronic payments exposures in "Payments System Risk and Public Policy."

Monetary policy is conducted within a policy framework that includes reserve requirements, access to the discount window, examination and supervision, and interest rate controls. This framework involves implicit taxes and subsidies for banks, which may or may not be necessary for the effective conduct of monetary policy. In "Financial Deregulation, Monetary Policy, and Central Banking," Marvin Goodfriend and Robert King conclude that they are not. They argue that monetary policy -- managing the stock of high-powered money to influence the price level and economic activity -- can be conducted completely apart from the banking policies in which the Federal Reserve is engaged. In particular, they question whether public lending to particular firms through the discount window is either necessary or appropriate. If it is not, the Federal Reserve could greatly curtail its costly regulatory and supervisory activities.

Financial firms are increasingly competing in a global marketplace. This competition is taking place not only among private firms, but also among regulatory systems as nations seek to attract a greater share of the international financial services market. Standards of leverage, accounting rules, levels of supervision and the reach of government safety-nets differ substantially around the world, but pressures for greater coordination of regulatory policies are developing as financial firms relocate activity to more favorable regulatory climates. In "The Process of Innovation, Institutional Change, and Regulatory Response in International Financial Markets," David Folkerts-Landau and Donald Mathieson review international differences in regulatory policies and financial structures and the complex forces leading to change. They examine efforts to achieve greater coordination of regulatory policies and explore possibilities for improving the efficiency, stability, and integration of international financial markets.

The U.S. has had a specialized housing finance system with pervasive government involvement since the 1930s. That system is now coming apart as a result of a number of pressures. The problems of the savings and loan industry and the recent bankruptcy of its deposit insurer, the FSLIC, have received considerable attention, but the role of the federally sponsored secondary mortgage market agencies also merits reassessment. In "The Future Structure of the Housing Finance System," John Weicher concludes that the FSLIC recapitalization passed by the Congress is inadequate to address the full scope of the S&L problem. He evaluates a range of options for coping with the near-term problem, including a merger with the FDIC fund. Weicher also examines a range of proposals for the secondary agencies, including privatization. Finally, he examines the underlying rationales for government involvement in housing finance, and the operation of a system with a diminished federal presence.

The regulatory system in the U.S. imposes a mix of burdens and subsidies on regulated firms. Historically, changes in financial regulation have occurred as a result of market and political forces, as well as competition among regulators both in the U.S. and abroad. In the final study, Edward Kane examines ways to improve the functioning of the regulatory system within a framework that incorporates the influence of these forces in "How Market Forces Influence the Structure of Financial Regulation."

These studies represent a comprehensive review of financial services regulatory issues that is unique in its scope. The concluding chapter synthesizes the major implications and policy conclusions.

Paper No. 1

Redefining Financial Markets

William S. Haraf and Rose Marie Kushmeider
American Enterprise Institute

Financial markets in the United States and abroad have undergone vast changes over the past decade. As legal and regulatory barriers to competition among different types of firms have eroded, new products and new methods of delivering financial services have emerged. Commercial banks, investment banks, thrifts, insurance companies and finance companies are increasingly competing for the same business in a global marketplace. This chapter describes the major changes that have occurred over the past decade and analyzes the forces that have shaped our financial system.

Six broad categories of financial change have significantly affected the financial services industry in recent years: (1) the securitization of lending; (2) the development of a broad range of new financial products and services; (3) an expansion of the geographic markets served by financial firms, both nationally and globally; (4) a growing number of mergers, acquisitions, and other affiliations both within the financial services industry and between financial and nonfinancial firms; (5) important new developments in the payments system; and (6) increasing financial strains among depository firms. The economic forces driving these changes include greater volatility of asset prices and exchange rates; significant technological breakthroughs; increased interdependence among nations; and public policies, in particular, regulatory policies.

The process of securitization, the substitution of marketable debt instruments for direct credit, has had a profound effect on financial markets. Securitization has provided substantial benefits in the form of a broader range of choices for borrowers and lenders, increased liquidity, and new opportunities to diversify and tailor risk exposures. At the same time, it has altered the role of financial intermediaries in the credit generating process, and has affected their profitability and exposure to risk. Many commercial banks and savings and loans in all size ranges have responded to this process by refocusing their resources to originating, distributing, and servicing obligations. Although commercial bank and thrift organizations are largely prohibited from underwriting and dealing in securities by law, some have expanded their securities activities through a variety of new channels.

New financial products have also emerged. Financial innovations, both on and off the balance sheets of financial firms, have been designed to provide greater liquidity, transfer risk, tap new sources of credit and equity, or reduce the cost of regulation. Many of these products would not have been feasible or profitable without breakthroughs in technology and in our understanding of the market for contingent claims.

Geographic expansion by financial firms has broadened the range of choices for consumers and increased competition. Today, cash management services, money market mutual funds, and other "bank-like" services are offered by retail and securities firms on a nationwide basis. In turn, depository firms have circumvented branching restrictions through the use of holding companies and limited service affiliates. Legislation at the state level has fostered interstate banking through regional compacts and other reciprocal agreements, and the federal government has authorized the acquisition of failing banks and thrifts by out-of-state entities on a temporary basis.

The globalization of financial markets has also introduced an important new element to competition. Branches and affiliates of foreign financial firms have become important competitors to U.S. firms, both in the U.S. and around the world. Indeed, by some measures, U.S. financial service firms have lost their position as the leading international suppliers of financial services. The growth of international banking has been encouraged by regulations affecting both the scope and cost of domestic operations. In turn, it has brought pressure on regulatory authorities around the world to attempt to coordinate their policies.

In recent years, financial firms have used mergers, acquisitions, and other forms of affiliation to organize in order to offer a full range of financial services or to integrate financial services with other lines of business. The Bank Holding Company Act and the Savings and Loan Holding Company Act present obstacles to integrating banking with other financial and nonfinancial businesses. Nonetheless, many nonbank financial firms, retailers, and industrial-based companies have used limited service banks or a single savings and loan to offer banking services along with other financial and nonfinancial products and service.

Developments in the payments system have raised new public policy concerns. Very rapid growth in the dollar volume of payments, particularly over the wire transfer systems, has greatly increased the credit exposures of participants. The main public policy concern with the operation of CHIPS, a net settlement system, is systemic risk, while the concern with Fedwire is the exposure of public funds to credit risk. A separate and controversial issue concerns the effects of affiliate relationships between firms with direct access to the payments system and other financial and nonfinancial firms on the integrity of the payments system.

The rapid pace of change in financial markets has been accompanied by record numbers of problem and failed commercial banks and thrifts. For nearly fifty years, the deposit insurance system was credited with maintaining a safe and sound financial system. Over the past decade, however, inflation and disinflation accompanied by volatile interest rates, regional economic disparities and regulations that have limited the ability to adapt to rapidly changing market conditions have produced growing strains on the financial system. Today, it is widely recognized that deposit insurance, itself, provides perverse incentives for risk taking, that have been exacerbated by forbearance and failure resolution policies.

In conclusion, public policies have played an important role in the evolution of the financial services industry through laws and regulations affecting the scope and cost of operation of financial firms. The incidence, effectiveness, and costs of financial regulation, however, fall unevenly on financial firms. Some are highly regulated while others, providing essentially similar services, are not. As a result, the intended effects of regulations have often been eroded by competitive pressures for efficiency and innovation. This chapter illustrates the variety of ways in which the private financial system has responded to profit opportunities created by legal and regulatory constraints.

Competitive pressures will continue to be an important force shaping the financial services industry. Firms will find ways to offer the types of services customers want, in the combinations they desire, at the lowest possible prices. The financial services market will evolve as firms operating outside the regulatory system continue to offer services similar to those provided by regulated firms, and as regulated firms continue to exploit loopholes in existing laws and regulations.

In evaluating public policy toward the financial system in the face of the tremendous changes that are continuing, it is important to bear in mind the competitive constraints on what can usefully be accomplished by regulation. This chapter illustrates that regulation, more often than restraining competition, has over time simply forced it into new channels. In the process resource allocation has been distorted and unnecessary costs have been imposed on consumers, shareholders, and taxpayers.

The purposes of financial markets are to channel savings to their highest valued uses, provide liquidity, and allocate risk. The essential role of government should be to ensure that these functions are undertaken efficiently and fairly, and that financial market participants are not themselves a source of disturbances to the overall economy. The chapters that follow evaluate how well existing regulations fulfill this essential role and, where they fall short, develop proposals for reform.

Paper No. 2

Risk and Solvency Regulation of Depository Institutions

George J. Benston, Emory University
George G. Kaufman, Loyola University

Although much of extant depository institution or "bank" regulation was initially introduced to control risk and increase solvency, it has increasingly failed to achieve either objective. In the process, regulation has interfered with the efficiency of the banking system and has hindered its ability to compete with an increasing number of firms offering competing products but not subject to the same regulation. This paper proposes an alternative to the present system of risk regulation that will both reduce the cost of bank failures to society and improve the efficiency of the banking system.

The first half of the paper reviews the initial reasons for regulating depository institutions and the types of risks banks assume, and evaluates the success of the regulations in controlling the risks and achieving their objectives. The analysis concludes that the principal reasons for contemporary bank regulation are protection of the insurance fund, limitations on competition, and minimizing possible disruption from bank failures. But regulation for these purposes is not warranted and, more importantly, is not now working. Advances in computer and telecommunications technology and increased financial volatility have overwhelmed the ability of the regulations to perform as intended. As a result, the incidence of bank failures, in particular the failure of thrift institutions, has bankrupted the FSLIC, weakened the FDIC, and imposed an estimated $40 billion cost to the taxpayer that is continuing to expand rapidly.

An underlying cause of the increased risk taking is the extant structure of federal deposit insurance, which has weakened the strength of market discipline imposed on the banks by depositors, rewarded risk taking by reducing the cost of deposit funds for such ventures, and permitted economically insolvent institutions to continue to operate for considerable time at high societal costs. Previous proposals have focused on the use of risk-sensitive insurance premiums to correct the problem, and more recently, on separating the risky and nonrisky aspects of banking to organize "fail-safe" or "narrow" banks. The limitations of both proposals are demonstrated.

As an alternative, the paper proposes more timely failure intervention before the economic or market value of a bank's net worth becomes negative. Hypothetical capital requirements and reorganization rules are developed for commercial banks. If on a market value basis the capital-to-asset ratio of the entity offering federally insured deposits -- the bank or bank holding company -- is above some minimum level, say, 10 percent, it is subject to minimum supervision. If its ratio declines below ten percent but is above, say, three percent it becomes subject to progressively intensive supervision and restrictions are imposed on dividend payments and interaffiliate flow of funds. If its ratio declines below three percent, ownership of the institution is transferred to the FDIC for recapitalization by the previous owners, sale, merger, or liquidation. Thus, the bank would always be operating with its own capital funds only.

This proposal requires market value accounting and frequent and accurate monitoring and the potential problems in achieving both of these conditions are discussed. The paper concludes that more timely failure resolution has a number of major advantages:

1. As there would be little, if any, loss to the deposit insurance funds, insurance premiums could be reduced and regulations restricturing bank powers on the basis of risk can be removed. This would permit banks to operate more efficiently.

2. Increased market discipline would be imposed by shareholders, subordinated debt holders, and bank managers. This would improve bank solvency.

3. All banks would be treated equally regardless of size or structure.

Paper No. 3

Financial Stability and the Federal Safety Net

Anna J. Schwartz
National Bureau of Economic Research

The model on which the quest for financial stability was based during the preceding half century is flawed. That model, a conception of the New Deal, regards banks as imprudent risk takers, vulnerable to the tendency for a run at one bank to lead to runs at other banks. Accordingly, banks were hemmed in by regulations that limited entry into the industry, the services they were authorized to offer, the prices they could pay and charge, and the geographical areas where they could operate. Since the regulations protected the monopoly position of existing banks and inhibited effective competition, the banks initially were comfortable with the New Deal approach.

Events have overtaken that model and it cannot be restored. The basic fallacy underlying the model is its emphasis on inherent instability in triggering bank difficulties. Banks are no more prone to imprudence than nonfinancial firms. Mismanagement and fraud occur from time to time, but there is no evidence that it is more widespread than in industry in general. Moreover, individual bank insolvency need not have contagious effects on other solvent institutions. In most cases of individual bank failures in this country and elsewhere, runs have not occurred. In the rare instances when runs ignited panics during the past two centuries, institutions did not exist or authorities were unschooled in the practices that prevent such a development, and the private sector had reason to doubt the dependability of preventive arrangements.

In the case of depository institutions, government is assigned the responsibility of protecting the functioning of the transactions and payments mechanism that they operate. The tripartite safety net in the present model for financial stability, consisting of deposit insurance, a lender of last resort, and regulation, relies on regulation to reduce the risk to the impairment of the payments mechanism. It calls on a lender of last resort to inject funds into the banking system to preclude panics in which it is assumed that depositors shift from deposits to currency. Had there been no banking panics in the United States from 1930 to 1933, deposit insurance as a device to protect the circulating medium would have been redundant. Because of this historical accident, federal deposit insurance was adopted to serve that purpose. Deposit insurance, however, is not essential to prevent panics, given a reliable lender of last resort.

The model that I propose assigns major responsibility for financial stability to monetary authorities to assure the basic prerequisite of price level stability. The model provides for an organization and the deregulation of the depository intermediary structure to encourage market efficiency with selected safeguards against excessive risk taking. Depository intermediaries would be free to establish firms where they chose, to pay whatever interest is required to obtain funds and to offer a variety of services anywhere in this country and internationally where their presence is welcome. Possible restraints on their activities, including off-balance sheet activities, might be capital requirements, marking assets to market, provision of information to authorities, and double liability for shareholders. The intent of the restraints would be to shift risks of depository intermediation to shareholders from the government safety net. The cumbersome existing regulatory framework might be streamlined in one agency covering all depository intermediaries. The lender of last resort would operate only under extraordinary conditions of a panic that led depositors to shift to currency, rather than redepositing their funds in another institution. The aim of deposit insurance, which could be privately administered, would be to provide depositors and creditors in reorganized or closed institutions immediate access to the full value of their deposits or their claims.

The paper is in five sections. Section I examines historical antecedents of current banking difficulties in this country and worldwide.

Section II deals with misconceptions about bank operations in the 1920s and the bank failure record of 1930-33 that evoked the regulatory provisions subsequently imposed on U.S. depository institutions. The section also explains why the efforts to limit intermediary competitive behavior broke down. Price level instability led to interest rate instability. Financial innovations -- a response to interest rate instability and regulation -- in combination with technology contributed to the unraveling of the skein of regulatory controls.

Section III discusses deposit insurance. Until the recent wave of depository insolvencies, federal deposit insurance was widely acclaimed as the greatest success of the New Deal. Now the need for reform of the program is generally accepted, although there is no agreement on the details. The factors that have been undermining deposit insurance are explored, principally price level instability during the past two decades. In addition, why other countries that had felt no need for such a program, adopted some form of deposit insurance, beginning in the late 1960s, is given some attention. Deposit insurance may be desirable even if contagious effects of bank runs are precluded by an effective lender of last resort.

Section IV discusses the role of monetary authorities in the current financial setting. The main responsibility of monetary policy is to achieve price stability. There is no well understood prescription to achieve price stability other than limited growth of the monetary base that the authorities alone determine. The authorities should be held accountable for the actual price level outcome.

In addition, the authorities remain the ultimate source of liquidity for the financial system.

Section V asks whether financial stability can be attained in a deregulated financial environment once the transition from the present situation has concluded.

Despite all the changes in bank balance sheets and their off-balance sheet activities that innovations have led to, banks still perform traditional functions as providers of payments, intermediary, and risk-sharing services. Some of the changes in banking and financial markets have the potential to reduce risk -- interest rate and currency swaps, financial futures come to mind.

But even if each individual asset depository intermediaries acquired appeared to be liquid and safe, that would not guarantee that all such assets in the aggregate would therefore be liquid and safe. Financial stability to a large extent depends on factors beyond the control of an individual intermediary as well as of all intermediaries as a class. These factors include monetary authority actions that do not destabilize the price level and real economic activity. Given a stable monetary environment, price level stability will follow and in such an environment, a deregulated financial system, besides producing a socially optimum allocation of resources in banking, with resulting lower costs and prices for banking services, will be compatible with financial stability. Without a stable monetary environment, there cannot be financial stability and a deregulated financial system will come to grief.

Paper No. 4

Financial Deregulation, Monetary Policy, and Central Banking

Marvin Goodfriend and Robert G. King
University of Rochester[1]

Overview

Financial deregulation is widely understood to have important economic benefits for microeconomic reasons. Since Adam Smith, economists have provided arguments and evidence that unfettered private markets yield outcomes that are superior to public sector alternatives. But financial regulations -- specific rules and overall structures -- are sometimes justified on macroeconomic grounds. Dividing the actions of the Federal Reserve into monetary and banking policy, this paper finds that financial regulation cannot readily be rationalized on the basis of macroeconomic benefits, especially those from monetary policy.

There is a consensus among professional economists, including academic analysts and Fed experts, that monetary policy can be executed without supporting financial regulations. This consensus reflects an understanding of the central role of open market operations. There is, of course, substantial disagreement among economists concerning the nature and magnitude of monetary policy's influence on the price level and real activity, but this should not mask agreement on the central role of open market operations in the management of high-powered money. Nor should it obscure the general agreement that there is an important unique role for the public sector in the management of money. However, it bears repeating that monetary policy can be executed without supporting financial regulations.

Banking policy involves regular lending and emergency financial assistance to banks and other institutions. Many aspects of Fed lending resemble private sector behavior in borrowing-lending relationships. In particular, there is a useful analogy between private lines of credit and Fed discount window lending. Fed regulation and supervision support banking policy in much the same way as loan covenants and monitoring support private lending.

With regard to its central banking function, then, the value of Fed regulation and supervision depends on the need for banking policy. In the credit market, however, the Federal Reserve is only one of many competing entities-- though a large and well-financed one -- and demonstration of a desirable pattern of Fed intervention must involve evidence of a relative advantage for the public sector or a market failure deriving from inappropriate private incentives. We know of no studies that decisively document this advantage. Moreover, banking policy may influence outcomes in banking and financial markets by subsidizing certain economic activities, prompting the erosion of private arrangements for liquidity and encouraging risk taking. On these grounds, we conclude that it is difficult to make a case for central bank lending policy and supporting public financial regulation.

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[1] Marvin Goodfriend undertook this paper while on leave from the Federal Reserve Bank of Richmond.

Analysis

Our development of these ideas proceeds as follows. We begin by providing definitions of monetary and banking policy. By monetary policy, we mean changes in the total volume of high-powered money (currency plus non-interest bearing bank reserves). Other central bank actions involve (i) changes in the composition of the asset side of the central bank's balance sheet, holding the total fixed, or (ii) regulatory and supervisory actions of the central bank. We term these banking policy.

In order to ask whether monetary and banking policy require supporting regulation, we must provide a detailed description of the operation of markets without regulation. We undertake this construction by combining key facts about how unregulated transactions presently occur (in the U.S. and other countries) with appropriate microeconomic, macroeconomic and financial theory.

Monetary Policy

We first consider financial deregulation and monetary policy, beginning by analyzing monetary policy in a fully deregulated environment. Monetary policy involves the manipulation of high-powered money by the central bank to manage nominal variables like the price level, the inflation rate, and the nominal interest rate and possibly to temporarily influence outcomes for employment and output. It can be undertaken in a fully deregulated environment because there is a private sector demand for high-powered money (currency and bank reserves) even in the absence of financial regulations. Further we illustrate how a prominent feature of Fed monetary policy, interest rate smoothing, is undertaken in such an environment. We conclude by pointing out the irrelevance for monetary policy of a well-known financial regulation, reserve requirements, under the Fed's preferred interest rate monetary policy instrument.

Banking Policy

We then discuss deregulation and banking policy. Again, we begin by considering a fully deregulated environment, outlining the character of private borrowing and lending transactions. In unregulated markets, lenders face many potential problems that arise from the fact that borrowers can take actions to influence the likelihood that loans will not be repaid. Thus, borrowers and lenders agree on sets of rules and restrictions to accompany loans that, for example, protect the lender against damage to the loan collateral. Restrictions on the borrower's range of actions are ultimately in the borrower's interest, since they lower the cost of the loan.

More generally, loan design involves the costly accumulation of detailed information about borrowers, both for the purpose of sorting borrowers into risk classes and for the purpose of designing covenants. Like many other economic activities, information production is highly costly when undertaken quickly without development of systems and experience. For this reason, lending is typically undertaken in the context of long-term relationships, in which information production can be undertaken in a less expensive manner. For example, continual monitoring of potential borrowers is a particularly important feature of the provision of line-of-credit services. Line of credit arrangements permit firms to obtain funds suddenly, when irregular needs arise.

A major banking policy is the public provision of line-of-credit services through the Fed discount window. As in private sector loans, regulation and supervision is a central component of Fed lending, i.e., a necessary component of banking policy.

The standard rationale for public lending involves the idea that the central bank can lend selectively to illiquid but solvent banks in a way that private markets cannot. Thus, we analyze the distinction between illiquidity and insolvency as a means of judging the appropriateness of public line-of-credit services.

Only if information is incomplete and costly to obtain is there a valid distinction between an illiquid and insolvent financial institution. But costly and imperfect information does not necessarily imply that banking policy is beneficial. For example, in operating a discount window, the government faces the same general type of problem as a private lender when there is incomplete and costly information. If it lends to a pool of undifferentiated risks, then to break even it must lend at a penalty rate equal to the private market pooled rate. However, in competition with private lines of credit, such a pricing policy would only attract unprofitable risks. Hence, indiscriminate lending would be undesirable.

Alternatively, a central bank could supervise, i.e., evaluate banks and selectively lend based on the information that supervision actually generates lending to the banks that would face pooled private market prices which left them illiquid but not insolvent. If these supervision costs are taken into account and they are at least as great as those of the private sector, then this banking policy breaks even or subsidizes illiquid banks. It could not penalize illiquid banks who have the option of using competitive private credit lines.

As with many other areas of government intervention, then, the efficacy of discount window lending turns on the relative efficiency of the government and the private sector in undertaking a productive activity. We know of no analysis that documents the relative advantage of the Federal Reserve in this area. Plausibly, the private market is superior because it is difficult for the government to actually lend only to illiquid but not insolvent banks.

Response to Crises

Finally, we discuss how monetary and banking policy could react to system-wide disturbances, including banking crises. We conclude that monetary policy can effectively and desirably limit crises arising from a widespread demand to convert deposits into currency. Illustrating our point, we interpret Walter Bagehot's "lender of last resort" rule as an irregular interest rate smoothing monetary policy. In contrast, banking policy can do little to influence such events. But we explore other potential roles for banking policy in response to system-wide disturbances.

Institutional Structure

In concluding, we raise a set of issues dealing with the institutional structure of the Federal Reserve. In particular, given that the Fed currently plays the twin roles of monetary authority -- charged with execution of monetary policy -- and central bank -- charged with execution of banking policy -- we note that there is potentially an important conflict between these roles. We discuss the potential benefits of restructuring the Fed so as to separate its monetary and banking responsibilities.

Paper No. 5

Payments System Risk and Public Policy

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The United States payments system includes a large number of financial institutions and institutional arrangements, which daily transmit over $1.4 trillion. The large-dollar, wire transfer components of this system (Fedwire and CHIPS) account for nearly 80% of the total dollar volume. The magnitude and complexity of wire system transfers has raised both public and private concerns about their safety. In particular, the Federal Reserve System has argued that the financial system's overall stability is importantly influenced by the type of payments transactions undertaken. These concerns have made the Fed oppose potentially important reforms in bank holding company structure, on the grounds that they would threaten payment system stability. It is therefore important to evaluate the sources of payments system risk, and its relation to the structure and functioning of private financial firms. In order to focus on issues of immediate policy concern, this paper analyzes payments system risk under the existing set of regulations and technology. Federal Reserve involvement in the wire transfer system is taken as given, as is its guarantee of payments finality (under Regulation J).

Three particular aspects of the U.S. payments system and its stability are evaluated here.

1. Does settlement risk on the large-denomination wire transfer networks (CHIPS and Fedwire) threaten the stability of individual banking firms, or of the financial system as a whole?

2. What is the proper way to control daylight overdrafts on Fedwire?

3. Are there any payments-system-related reasons why commercial firms should not be allowed to affiliate with banks?

Payments System Risk Defined

At its most basic level, a payments system is a mechanism for transferring claims on wealth among economic agents. No payments system risk would exist if all institutions' payments were cleared and settled continuously. Credit problems arise, however, because many trades exchange value against a promise to pay. Payments are recorded continuously during business hours, but settlement -- the transfer of medium of exchange balances -- occurs only once daily, at the close of business. There is the possibility that a system participant will be unable to meet the commitments it made during the business day. Settlement risk is a particular form of credit risk.

Private payee banks bear the settlement risk on CHIPS, giving them the incentive to monitor, control, and price such credit extensions. Some observers have argued that CHIPS is subject to negative externalities, in the form of possible "systemic" effects from a failure. Specifically, one bank's failure to settle its net debit position could impose losses on other banks, setting off a string of failures. Because Fedwire payments are guaranteed at the time they enter the payee bank's settlement account, the Fed bears settlement risk in conjunction with its payments system operations. Importantly, this risk is not priced in any way. The social costs of unpriced Fedwire credit are similar to those of mispriced federal deposit insurance: bankers have private incentives to bear excessive risks and to misallocate real resources.

Systemic Risk on CHIPS

Potentially, the most important issue associated with payments system risk is the possibility that contagious failures could occur as a result of CHIPS daylight credit extensions. (Payments finality on Fedwire makes contagion there impossible.) However, equating an initial settlement failure with a contagious string of bank runs ignores the intended functioning of the Federal Reserve's discount window. An institution which is unable to settle might be insolvent or merely illiquid; the lender of last resort should provide liquidity to solvent firms.

Bankers routinely evaluate and assume credit risks. While there is nothing qualitatively different about payments system risk, the extent to which such credit risks are concentrated among the nation's largest banks makes their effective control imperative for both managers and regulators. Accordingly, one substantial regulatory gap exists: intra-day credit extensions are not subject to the limitations that apply to overnight credits. If private firms' lending decisions must be regulated, simple parity dictates that these rules must apply to daylight positions as well as those undertaken overnight.

Conclusion #1: Daylight overdrafts constitute one important type of risk for at least some banks. Normal safety and soundness regulation therefore requires that these risks be properly monitored and controlled.

Conclusion #2: Section 23A of the Bank Holding Company Act should apply unambiguously to daylight overdrafts, as should other limitations on the proportion of net worth a bank may lend to a single borrower.

Controlling Fedwire Overdrafts

Fedwire overdrafts have expanded greatly in recent years primarily because the existing system provides insufficient incentives to avoid daylight overdrafts. It therefore appears likely that Fedwire overdrafts can be substantially reduced if transactors are given even a small incentive to improve payments synchronization. The question is then how the proper incentives can best be provided. The Fed's current "Payments System Risk" policy establishes a specific line of credit for each bank, though utilization of the line entails no explicit cost. While this system does introduce some incentive to synchronize payments, it suffers from significant shortcomings.

Two other means of reducing Fedwire overdrafts have been suggested: collateralization and explicit pricing of the daylight credits. Corrigan's [1987] proposal that large banks be required to hold sufficient (interest-bearing) clearing balances to avoid Fedwire overdrafts would occur less frequently with the higher level of clearing balances. The difficult question raised by Corrigan's proposal is whether the payments system (or Fedwire alone) should be constrained to operate without credit extensions. This subtle (and central) question deserves serious economic analysis.

Conclusion #3: The Fed should explicitly evaluate whether paying market interest rates on (at least some) clearing balances would be a socially efficient way of producing payment system reliability.

Explicitly pricing Fedwire overdrafts has considerable intuitive appeal: with properly priced credits, private transactors would determine for themselves which overdrafts are worth having, and which are unprofitable. However, Fedwire's technological capabilities are likely to limit the extent to which explicit pricing can provide the sole means of controlling daylight overdrafts.

Conclusion #4: The credit risk of daylight overdrafts on Fedwire should be priced to encourage transactors to synchronize their payment inflows and outflows more closely.

Commercial Firm Affiliates and the Payments System

The Fed has recently asserted that the payments system activities of banks constitute an important reason why they should be prohibited from affiliating with commercial firms. Essentially, the contention is that banks would be made more likely to fail because they might extend large intra-day credits to affiliated firms in the course of making payments for them. It is unclear why commercial affiliates present materially different risks from those the Fed currently tolerates for financial affiliates. In any case, imprudent credit extensions would be much less likely if Section 23A and other requirements for loan portfolio diversification applied to daylight overdrafts. Enforcement of these restrictions could be aided by applying the Fed's emerging technological ability to monitor Fedwire overdrafts continuously for any bank with a large commercial (or other) affiliate. The public policy issue of bank affiliations with commercial firms must be decided on grounds other than payments system risk.

Conclusion #5: If Section 23A clearly applied to daylight overdrafts, existing regulations governing corporate separateness within a bank holding company would be sufficient to protect payments system stability.

Conclusion #6: The Fed's opposition to the affiliation of commercial and banking firms cannot be credibly supported by concerns about discount window access.

Paper No. 6

The Future Structure of the Housing Finance System

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The housing finance system has been coming apart for more than a decade, under the impact of volatile inflation and technological change. The Federal Savings and Loan Insurance Corporation has been bankrupted as a substantial minor fraction of savings and loan associations have become insolvent. Public policy concern has shifted from the role of the S&Ls in housing finance to their existence as distinct financial institutions. At the same time, there has been serious discussion of fundamental changes in the role of the major federally-sponsored secondary mortgage market agencies. The possibility of privatizing both the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation has been raised in studies by the Reagan Administration and by a Freddie Mac advisory task force. This issue has been obscured by the spectacular pyrotechnics of the FSLIC crisis, but it is probably more fundamental.

Since the 1930s, the housing finance system has consisted of two distinct sets of institutions with different purposes: the S&Ls, specialized lenders with preferential access to capital markets through the Federal Home Loan Bank System and with deposit insurance through FSLIC; and FHA and FNMA, intended to broaden the base of housing finance by developing new mortgage instruments and attracting new sources of mortgage funds. Both systems were able to thrive as housing and the economy prospered in the early postwar period. From the early 1950s through the mid-1960s, the S&Ls gained market share as they copied the innovations of FHA. When monetary policy became inflationary around 1965 and Reg Q was extended to S&Ls, the specialized system began to disintegrate. The S&Ls borrowed short and lent long, and were vulnerable to unexpected inflation. During the 1970s, public policy responded slowly to their problems. Various proposals to expand their asset and liability powers were rejected by Congress. Broad new powers were finally granted in 1980 and 1982. By then the S&Ls were losing deposits to money market mutual funds and the industry as a whole was insolvent, by market value accounting.

Generally accepted accounting principles, however, permitted the S&Ls to defer recognizing their losses, and public policy gave them still greater leeway. Insolvent institutions were allowed to continue operating, in the hope that interest rates would fall. This strategy was at best partly successful. The industry regained solvency, but the number of insolvent institutions, and the cost to FSLIC of closing them, both grew steadily. The Bank Board argued that abuse of new powers was responsible for the problem, and has limited direct investment in real estate. This argument has not been supported by independent research.

At present the FSLIC faces costs of $40 billion or more in order to close insolvent S&Ls. The recapitalization plan passed earlier this year is obviously inadequate; in fact, the estimated cost to the FSLIC rose by $10 billion during the time it took Congress to approve the $10 billion recap plan. Even the total resources of the Home Loan Bank System would be insufficient. Merging the insurance funds could spread the costs to commercial banks, but is also likely to be inadequate. Some insolvent S&Ls still have franchise value, and other institutions might be willing to acquire them in order to enter new markets. Ultimately, however, the taxpayer is likely to bear most of the cost. If that is to be the case, it would be preferable to close the insolvent institutions sooner rather than later. At its present schedule, the recap plan would take 15 years to solve the current problem.

If the insolvent S&Ls were closed and the losses paid quickly, and if the Benston-Kaufman proposal for timely reorganization were adopted at the same time, it would be possible for the remaining S&Ls to continue under a separate regulatory system. It would also be possible for S&Ls to continue as separate entities if the insurance funds were merged, as the mutual savings banks have done. But the rationale for a separate system is disappearing. The S&Ls have been moving away from their traditional role as their powers have expanded. Housing finance is now less important to them, and they are less important to housing finance. They are moving into mortgage banking, consumer-oriented commercial banking, and integrated real estate financing. None of these activities requires a separate regulatory system or deposit insurance fund. Some S&Ls continue to be portfolio lenders, specializing in Adjustable Rate Mortgages, but specialization is becoming harder as the S&Ls face increasing competition from the secondary market agencies and the overall financial structure continues to evolve.

The problems of the S&Ls after 1966 offered new opportunities to FNMA. It became an active portfolio lender with a line of credit and an implicit government guarantee arising from its agency status, which are equivalent to deposit insurance for S&Ls. As a giant S&L, FNMA suffered the problems of S&Ls on a giant scale in the early 1980s; it had a negative net worth by 1981. Public policy again temporized, and FNMA was able to leverage its guarantee in the capital markets, borrowing at favorable rates to buy mortgages. Its gamble succeeded when interest rates fell, but it remains vulnerable to unexpected rate increases. There is no important public benefit from FNMA's portfolio lending operations; other investors would be willing to hold most of its mortgages.

The future role of FNMA and Freddie Mac is the most important long-term question concerning the housing finance system. Their major public purpose now is their demonstration effect as innovators of mortgage-backed securities. This role also involves a subsidy, however, and the subsidy may be inhibiting the demonstration. Agency status and federal guarantees have so far been the only satisfactory way of reducing default risk for mortgage security investors, by shifting it to the federal government. Private firms are now showing interest in issuing conventional mortgage Remics without a government guarantee. The agencies, however, have an advantage of 20 to 40 basis points in the yield investors will accept, because of their status, and the private market has been slow to develop.

This small cost advantage suggests that the housing and mortgage markets would continue to function satisfactorily if subsidies to the secondary market were terminated. FNMA and Freddie Mac could be charged for the value of their agency status, but this is likely to prove politically difficult, both to establish the appropriate fee and to change it when warranted. Alternatively, the agencies could be privatized, as discussed and generally recommended in both the FNMA and Freddie Mac reports.

Privatization could occur through several mechanisms. The government could choose to buy and resell FNMA's stock, or buy its bonds and exchange them for FNMA assets. Transition problems include the implicit guarantees, which might have to be made explicit for current debt would carry no guarantee; and FNMA's portfolio of pre-1980 low-yield loans, which might be bought by the government. Freddie Mac could be privatized by allowing the S&Ls and Home Loan Banks to sell its stock, and terminating its ties to the Home Loan Bank System and the Treasury. The Freddie Mac task force has suggested that the value of the stock would rise if the agency were privatized. Both agencies are probably viable as private secondary market firms, and both should be privatized at the same time.

The agencies have had other public purposes in the past, but these are becoming less important. They are supposed to provide countercyclical mortgage market support and to help "the first-time homebuyer." The former objective is probably impossible in a deregulated mortgage market, where cost rather than availability rations mortgage money. The latter can best be achieved through direct subsidies, perhaps channelled through GNMA.

The housing finance system of the future will look very different without specialized lenders and secondary market agencies, but it should "work," in the sense of providing funds for housing, as well as the current system has done. A national mortgage market is coming into existence. Further new instruments and new securities will be developed, making past policy issues obsolete. The appropriate public policy role is to avoid inhibiting innovation by substituting political for market judgment. Technological change is promoting functional specialization in the mortgage market. Mortgage banking in particular has become increasingly separated from portfolio lending, and other types of firms are setting up mortgage banking subsidiaries. Origination and servicing costs are declining as a result.

Through most of the paper, the policy judgment that housing deserves special treatment is accepted for the sake of analyzing the system. In conclusion, it is worth considering whether housing is special. One argument for housing preferences is based on externalities; the value of one house depends on the quality of neighboring houses, but the neighbors are not compensated for the benefit they confer. This is probably valid but the externality seems to be small. A second argument is the social value of homeownership; it is widely asserted but seldom demonstrated that homeowners are better citizens. Even if both arguments are true, they do not necessarily justify a specialized housing finance system or any other form of subsidy; the appropriate incentives can be provided through the tax system, probably more effectively.

The integration of the housing finance system with other capital markets has proceeded without much public outcry. The change in public policy may reflect a change in public attitudes; housing may be less socially preferred. The apparent public willingness to accept changes in the housing finance system should make it easier for policymakers to improve the overall financial system.

Paper No. 7

The Process of Innovation, Institutional Change, and Regulatory Response in International Financial Markets

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This paper examines how competition in international capital markets, financial market regulatory policies, and macroeconomic developments interacted in the major industrial countries to produce a period of rapid change in financial products, institutions, and regulatory policies since the mid-1970s. To consider the implications of these structural changes in international financial markets for the formulation of regulatory and supervisory policies in an international context, the paper focuses on three topics. There is first a review of the changes in international financial markets that have increased the interdependence between national regulatory policies in the major industrial countries. This involves an examination of the forces creating change in financial markets (including the role of regulatory policies and supervisory practices) as well as consideration of how these changes were transmitted across countries. There is next an analysis of the response of supervisory and regulatory policies to these structural changes, especially as they were reflected in attempts to achieve a degree of international coordination of these policies. Finally, there is an examination of current issues associated with formulating and implementing supervisory and regulatory policy in a world of increasingly integrated financial markets.

Both the extent and pace of structural change in the major markets during the past decade stands in contrast to the relatively stable mix of institutions and regulatory policies that existed in most of these countries in the 1950s and 1960s. While the timing of these structural changes naturally differed across countries, major domestic markets experienced rapid growth and major structural changes. New instruments and issuance techniques emerged; extensive changes occurred in the role of financial institutions; regulations have been liberalized; and supervisory practices were adapted to changing financial relationships. Many of these developments represent a continuation of trends that have been evident since the 1970s but whose pace has accelerated in the 1980s. The structural changes in these markets represent responses to major macroeconomic disturbances and imbalances, to technological advances in telecommunications and data processing, and to arbitrage opportunities created by differences in financial structures (including regulations, tax codes, and portfolio preferences). Most major countries have increased the scope for international financial transactions by reducing their restrictions on both short- and long-term external capital flows. Liberalisation has generally reduced restrictions on the products, activities, and location of financial institutions as well as on the interest rates that could be charged on loans or offered on liabilities. As these structural changes have taken place, integration between major domestic and offshore financial markets has increased. In part, this integration has been evident in the emergence of a common set of debt and equity instruments that are issued and traded on most major markets.

The structural changes in financial markets have had important implications for the formulation and execution of regulatory and supervisory policy in the major industrial countries. In particular, new instruments and markets have combined with new telecommunication technology to make it easier for financial firms to relocate some of their activities to a regulatory or tax jurisdiction of their choice, while the growing integration of markets has meant that disturbances in one national market are transmitted swiftly to markets in other countries. As a result, there has been a continuing feedback between changes in financial markets and regulatory and supervisory policies. For example, financial market regulatory policy, which has stimulated innovations in financial products and influenced the location of new activities (especially in the offshore markets), has been forced to adapt to the expanding international activities of domestic financial institutions and to the possibility of spill-overs of disturbances from other markets. In particular, the need for some cooperation in the design of national regulatory and supervisory policies in the major countries has come to be widely recognized, though the extent and nature of such cooperation between national authorities is still an important issue in theory and policy.

The final section turns to the issues associated with the coordination of supervisory policies across countries in a world of increasingly liberalized and integrated financial markets. Since many recent proposals for improving the stability of the domestic financial system have emphasized the need to improve the capital positions of financial institutions, the analysis focuses on the implications of recent changes in international financial markets for attempts to implement and monitor higher capital-asset ratios. There is an examination of the potential difficulties that could be created by the abilities of financial institutions to relocate activity across regulatory jurisdictions under alternative corporate forms; the extension of guarantees by parent institution to affiliates; the difference between tax, legal, accounting, and disclosure requirements in major countries; and the contrast between the extent of lender of last resort assistance and public sector deposit insurance guarantees that exist in different countries. These factors make it difficult to establish capital-asset ratios significantly different from those in other countries without creating some incentives for regulatory arbitrage. However, even if a coordinated approach to supervision of capital adequacy is to be adopted, there is still the issue of the form of that coordination.

Paper No. 8

Bank Holding Companies: Structure, Performance and Reform

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This paper looks at the case for and against the regulation of Bank Holding Company (BHC) financial and commercial non-bank activities. Overall, this paper finds that a strong case can be made for allowing BHCs to choose freely the portfolio of activities they so desire and that restraints on activity diversification may well have larger social costs than benefits.

In large part, the case for activity regulation depends on a conventional wisdom that (in a social welfare sense) bank services are somehow special. Specifically, it is often argued that transaction accounts and bank loans, respectively, provide important medium of exchange and credit intermediation functions that cannot be replicated by other firms. Consequently, a crisis of confidence or panic that destroys the stock of transaction accounts and loans will have severe externalities on the rest of the economy (extending well beyond the banking system). It is argued that to avoid panics activity regulation is needed to limit excessive "risk-taking" by banks. The general finding of this study is that the social costs to bank failure are usually vastly exaggerated due to confusing the costs of individual bank failures (which may be very small) with the social costs of pervasive panics encompassing all banks in the system. Historically, the latter have been extremely rare and usually the result of inappropriate Central Bank monetary policies. Thus, the social costs of an individual bank failure, and therefore its specialness, may be no more significant than any other firm.

Notwithstanding the weakness of the specialness argument, the case for activity regulation also depends on a widely held belief that a bank's insolvency risk will increase following conglomeration with unregulated (or even regulated) non-banking affiliates. Theory argues that the risk or probability of insolvency will be negatively related to the level of bank returns and capital adequacy and positively related to the underlying variance (risk) of those returns. While there appears to be evidence that BHC banks pay higher dividends and maintain lower capital ratios, than independent banks, there are often logical explanations for this other than excessive risk-taking--such as paying off acquisition debt and exploiting the double leverage option available to BHCs. Moreover, there is no empirical evidence that BHC management(s) have persistently exploited their banking affiliates by diverting credit to non-bank affiliates and/or dumping bad assets in the bank. Finally, evidence clearly demonstrates that the effects of BHCo. activity and geographic diversification, where allowed, has worked to reduce the underlying variance of holding company returns, and therefore to reduce the probability of insolvency.

There are at least three other arguments made by proponents of activity regulation in addition to the insolvency question. These are that activity extensions may increase the probability of (i) (electronic) payments system risk; (ii) conflicts of interest; and (iii) monopoly power and concentration. The major risk on private electronic payments systems such as CHIPS is (end of day) settlement risk due to participants running "free" daylight overdrafts. It is argued that non-bank participation on such systems, through an affiliated bank, would increase the probability of settlement risk failure. This argument seems, at best, tenuous. First, payment system transactions between a bank and its affiliate would be directly limited by Section 23A of the Federal Reserve Act. Second, there is no evidence, from financial market data, that non-bank firms have significantly higher risks of default than banks and financial firms in general. Third, the existence of settlement risk is a direct result of the mispricing of daylight overdrafts. Thus, a far more efficient policy would be to price these overdrafts correctly rather than using the current sledgehammer policy of blanket prohibition and limitations on bank-nonbank affiliations.

Conflicts of interest arise in all large multi-product business organizations and are a direct result of either information imperfections and/or monopoly power enjoyed by participating agents. Major conflict concerns, with respect to BHC's non-bank activities, include (a) restricting the supply of credit to competitors, (b) using a bank's monopoly power to tie customers to non-bank products of the BHC, (c) making loans to an affiliate to keep it in business, and (d) dissemination of inside information to an affiliate. By and large, the tremendous increase in competition in the market for financial services in recent years has severely limited a bank's ability to restrict the supply of debt finance to any one customer and/or to tie that customer to (other) non-bank products of the holding company, while inside information can be controlled if sufficient internal and external penalties and controls are put in place. Indeed, recent experience suggests that BHCs may have been relatively successful in the area of conflict control since they have been left untouched by recent insider-trading scandals.

Fear of market concentration and bank monopoly power has, in part, resulted in a current regulatory structure in which the BHCo. Act imposes more stringent limitations on vertical integrations than are imposed on horizontal integrations by the Sherman and Clayton Acts. The specific concern appears to be that banking is a monopoly industry and if it is allowed unrestricted entry into non-banking activities, it will extend its monopoly power to these more competitive markets. First, this argument patently ignores the fact that whatever monopoly power previously existed in banking has been significantly eroded by trends in technology, inter-state banking and competition from other financial firms. Second, this restrictive policy has important social costs that may well exceed any perceived benefits. Specifically, by preventing or constraining vertical integration the BHC Act limits economies of scope, limits economies of scale, limits efficient risk-sharing by restricting bank equity participation in the activities of non-banking firms and perpetuates agency problems by maintaining a false dichotomy in the market for corporate control (takeover market, etc.) among bank and non-bank firms.

So far, the case for activity regulation has been critically evaluated based on a supposition that the (one) BHC is the optimal organizational form within which non-bank activities should be carried out. However, this optimality is partly a result of existing restrictions on banks' debt market access, geographic diversification and activity diversification as well as tax and corporate separateness considerations. Many of the motivations to form (one) BHCs would disappear or become irrelevant in a fully deregulated environment in which banks had direct access to the debt market and could freely diversify whenever and into whatever they choose. In such an environment the most important benefit from a BHC structure would be corporate separateness which might well be outweighed by the benefits from alternative organizational forms such as the universal bank form (as in West Germany) or even the 100% Reserve Bank Holding Company structure in which transaction accounts are segregated from all other non-bank and bank activities in a separate affiliate. It may well be that the advantages of economies of scope and scale of a universal bank organization prove sufficiently strong, compared to corporate separateness considerations, to make this the optimal organizational form in a fully deregulated environment. By contrast the 100% Reserve Bank Holding Co. idea seems to have a number of disadvantages even compared to the current (one) BHC structure. In particular, this idea simply parlays credit risk into interest rate risk (unless asset and liability durations are matched), reduces the likely volume of credit intermediation services and encourages the growth of non-bank subsidiaries offering unregulated transaction-account like services.

In summary, the case against BHCs expanding their activities into the commercial and non-bank financial arenas, based on specialness, insolvency risk, transaction mechanism risk, conflicts of interest and concentration arguments, is rather weak and does not stand the test of theory or empirical evidence. Consequently, it is recommended that BHCs not only be allowed to choose the type and geographic range of activities they prefer from a firm value-maximizing perspective but also be allowed to convert (or revert) to a universal-type bank structure if they so desire.

Paper No. 9

The Future Financial Structure: Fears and Policies

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The elimination of geographic and product regulatory constraints on banks and other financial institutions and the revolution in information and computer technologies are changing the structure of our financial system in ways that are not immediately obvious. It seems likely, however, that the current structure of thousands of small financial institutions, operating in isolated and insulated markets, will eventually evolve towards a more openly competitive system populated by larger multiproduct financial institutions.

The objective of this paper is to examine analytically the concerns that have been voiced about the dangers of allowing a financial structure to evolve that is populated by large, highly-diversified, financial conglomerates. Should legislators or regulators intervene to prevent this from occurring, and, if so, in what ways?

There are some who fear that the current evolution will result in a highly concentrated financial structure, in which only very large, highly-diversified, and internationally-integrated institutions can survive. With fewer and larger institutions, it is feared, competition will give way to oligopolistic behavior, leaving smaller lenders, borrowers, and consumers of financial services worse-off than before. While not unique to the United States, this concern is deeply embedded in both our political and economic heritages, which extol the virtues of independence, smallness, and atomistically-competitive markets, particularly with respect to banks and financial institutions.

This study examines several key concerns that are commonly associated with large financial institutions. In particular, it analyzes the bases for the concern that such institutions will result in greater market concentration and in the widespread use of abusive anti-competitive practices such as predatory pricing and tying arrangements. In addition, the paper discusses allegations that large firm size and greater concentration will exacerbate potential conflicts of interest problems, undermine the soundness of the financial system, worsen the allocation of credit, and result in large firms having undue political power. Current competition policy, as represented by existing regulatory and antitrust standards, is also reviewed and evaluated.

Conclusions

A fundamental restructuring of our laws and regulations is now imperative. Sweeping reforms are long overdue. Policy makers have been paralyzed by battles over turf among competing industry segments, and battles to preserve public subsidies and protections. Private lobbying activity is not the only obstacle to regulatory reform. The subsidies provided by the regulatory system create business for regulators and rents for elected politicians, which they too have incentives to protect.

If Congress and the regulators fail to act, taxpayers will be left to underwrite an increasing amount of financial risk that is now being loaded on the system. Significant public benefits in the form of lower prices for services, an improved allocation of resources, and a broader range of choices will be lost.

Ideally, financial markets channel savings to their highest valued uses, facilitate payments, provide liquidity, and allocate risks to those willing and best able to bear them. Desired financial services are supplied at minimum resource cost. The government's objectives should be to ensure that these functions are undertaken efficiently and fairly, that financial market participants are not themselves a source of disturbances to the economy, and that the financially unsophisticated are protected. The AEI study clearly indicates that these objectives can be accomplished with a much less intrusive and more focused body of regulation than presently exists.

The paper's conclusions are:

1. Concentration in relevant product and geographical markets is unlikely to increase. While there will be fewer banks and financial institutions in the nation taken in its entirety, the number of competitors may well increase in relevant (economic) markets, and the level of concentration decline.

2. Competition will increase, not decrease. Concentration will decline in relevant markets, and, most importantly, entry barriers will fall because of diminished regulatory constraints. As a result, competition will be more vigorous than ever.

3. The fear that large, multiproduct, financial institutions will utilize tie-in sales and predatory pricing strategies to constrain competition is unfounded. The market conditions under which such strategies are effective will be eroded, and not enhanced, by the current structural evolution in financial markets. Further, present antitrust laws, and applicable legal standards, provide a sufficient safeguard against abusive tying and predatory pricing strategies.

4. The present regulatory standards and antitrust laws applicable to mergers among financial institutions provide a sufficient safeguard against mergers that would significantly restrain competition. If anything, the acceptable concentration ratio (or Herfindahl Index) levels specified in the current Antitrust Guidelines are unnecessarily low (or unnecessarily restrictive) to maintain competitive financial markets, and the importance attached to potential entry is too little.

5. The existence of large multiproduct, financial institutions does not significantly exacerbate the traditional conflicts of interest concern. Indeed, with more competitive markets, there will be less need for concern.

6. A financial system populated by large institutions is likely to be more stable than the one we now have. There is no evidence to support the contrary view.

7. While the political power of large banks and financial institutions is potentially of some concern, there is no evidence that large firms, or firms that operate in concentrated markets, have unusual political power. Existing empirical studies have not been able to discover a relationship between either firm size or concentration and political effectiveness. Further, it is not clear why large financial institutions, or large banks, should be treated differently from other large firms. If there is some reason to impose restrictions on size or concentration out of a fear of excessive political power, such a policy should be

extended to all firms and markets, and not just to financial institutions and markets.

8. The argument that the development of large banks and financial institutions will have an adverse effect on the allocation of credit is without substance. There is, in the first place, no reason to think that the overall allocation of credit is affected by the size of banks or financial institutions. Second, the development of large, multiproduct, multi-regional institutions should make credit markets even more perfect than they already are. If there is a reallocation of credit, therefore, it is likely to be market-driven. Thus, if credit reallocation occurs, it is likely to increase welfare, and not reduce it.

9. Finally, there seems to be no purpose served by continuing the present bureaucratic and costly review process used to evaluate the competitive effects of bank and thrift institution mergers. The process should be simplified so that such mergers need only meet the tests imposed by the antitrust laws.

Paper No. 10

How Market Forces Influence the Structure of Financial Regulation

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This paper develops a positive economic analysis of the process of financial regulatory reform. According to this analysis, economic efficiency requires that financial services be produced jointly with a set of external regulatory services. These regulatory services are designed to promote confidence in individual firms and to coordinate their activities in ways that enhance user convenience. No matter how well-reasoned or strongly felt professional economists' particular policy recommendations may be, they have little direct influence on the operative structure of financial regulation. What counts is the vigor of interindustry, interregional, and international competition among alternative suppliers of financial regulatory services and different suppliers' concepts of the kind of changes that can help them to gain additional revenue and market share.

Financial regulatory services are typically produced, marketed, and delivered in the context of an ongoing client relationship rather than sold on a transaction-by-transaction basis. In competing for clients, governmental regulators have two complementary advantages over private suppliers of regulatory services. Their governmental status confers reputational capital that permits them both to bear the financial strains of subsidizing critical elements in their service package for years on end and to manage self-interestedly the short-run flow of information concerning the effectiveness and cost-efficiency of their performance.

Regulatory markets may be seen to be imperfectly contestable ones, in which entry and exit costs are not zero. In recent years, the benefits of technologically driven declines in entry costs have been lessened by the reluctance of inefficient government suppliers either to exit or to adapt in timely fashion to changing economic circumstances. The paper shows that, in the absence of hidden regulatory subsidies, profit-driven changes in organizational form, plant location, and product line would tend to be stabilizing. Examples of this "structural arbitrage" are developed to illustrate two points: (1) how financial-services firms can transform their operations and their organizational form to reconstruct the "regulatory climate" within which they function, and (2) to clarify that regulatory migration undertaken in response to regulatory innovations can cause problems when elected politicians face insufficient incentives to monitor and minimize the full

costs for government agencies of producing regulatory services.

Both in the U.S. and abroad, individual financial institutions are revising their organizational structures and extending their product lines and geographic reach to serve new markets and in the process selecting a burden-minimizing set of regulatory microclimates for themselves. This structural arbitrage disrupts the inherited regulatory equilibrium, imposing what may be termed a "law of one burden" on competing regulatory entities, who must struggle to defend and redefine the borders of their domains.

The analysis pays particular attention to the growing intensity of competition from foreign regulators for opportunities to regulate domestic financial activities. The vigor of this competition has made it harder and harder for individual countries to keep foreign financial-services firms out of domestic financial markets and to keep domestic firms from expanding activities off-shore. Reductions in regulatory burdens that multinational and multipurpose financial firms win for themselves are generated by shifting real costs onto various taxpayers in hidden fashion. Most important of these hidden costs are unintended subsidies that flow from the improper pricing of explicit and implicit government and international financial guarantees.

This paper's industrial-organization perspective suggests that the difficulty of arranging durable patterns of international regulatory cooperation reflects difficulties inherent in forming and maintaining a world-wide cartel in any product or service. It is hard for national regulators to negotiate even bilateral rights to open offices in each other's regulatory territory, although the process is easier for close and longstanding allies such as the U.S. and U.K. Significant progress has occurred recently in two areas: arrangements to share flows of relevant information across the global regulatory community and efforts to reduce differences in the level and structure of individual countries' capital requirements.

The paper argues that market forces invariably alter the effects of regulatory reforms. Recognizing this, designing regulatory structures that work with rather than against efficient client adaptation provides the best chance of achieving society's regulatory goals. First and foremost, this means preventing regulators and regulatees from deliberately distorting the flow of information about market assessments of their performance and finances.

Paper No. 11

PRINCIPAL POLICY CONCLUSIONS AND RECOMMENDATIONS OF THE FINANCIAL SERVICES REGULATION PROJECT

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Introduction

Our system of financial regulation has evolved over the years in response to a number of economic and political objectives. Regulations have not always accomplished these objectives, and they often had unintended and unexpected consequences. The AEI studies illustrate the many parallels between financial regulatory issues and regulatory issues in other areas. Price controls, barriers to entry, and a variety of hidden taxes and subsidies have raised the cost of services, reduced the options available to consumers, and shifted costs and risks to taxpayers.

Nonetheless, there is a widespread belief that financial regulation is special. To a great extent, the current system was shaped by the macroeconomic cataclysm of the 1930s. The great depression had convinced lawmakers that unregulated and competitive financial markets posed serious risks to economic stability. Congress embarked on a far-reaching program of government involvement in the financial sector. It established a complex regulatory framework intended to restrain competition and a deposit insurance system intended to protect small depositors and to enhance financial stability.

Today there is broad agreement that the depression of the 1930s was unrelated to practices in private financial markets. Macroeconomic causes were responsible, not too much competition. There is growing recognition of the corrupting influence of the present deposit insurance system, and a greater appreciation for the positive role of competition in financial markets. Nonetheless, the barriers to competition, efficiency costs, and moral hazards of the present regulatory system are, in large part, a legacy of that painful episode.

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* This paper represents my own judgments about the principal policy conclusions and recommendations of the AEI study project. Although I have tried to be as faithful as possible to the analysis in the preceding papers, the project authors may not agree with all of my conclusions. I owe special thanks to each of the project authors, to members of the advisory committee, and to many others too numerous to mention both for their individual and cooperative efforts in connection with this project, and for giving me the benefits of their insights and experience.

The regulatory system has not contributed to macroeconomic stability. Indeed, by encouraging risk-taking and by limiting opportunities for diversification, it may have made the goal of stable financial system more difficult to achieve.

In recent years, volatile economic conditions, technology, and market innovations have subjected the financial system to new pressures. These pressures have exacerbated problems with existing regulation. The social costs of restrictions on competition and the integration of financial services have increased. Important market disciplines have eroded. Government agencies, and ultimately federal taxpayers, have assumed a rising level of financial risk through a range of credit, contingent credit, and insurance programs.

The present regulatory system is rife with implicit taxes, subsidies, and entry barriers that have reduced the efficiency of the financial system and shifted risks to taxpayers. Viewed together, the AEI studies point toward reducing these distortions insofar as possible. The main message of the AEI studies is that it is possible to achieve the goal of a safe, efficient, and fair financial system with regulations that are less intrusive to the functioning of free markets.

The principal policy conclusions and recommendations of the AEI studies can be grouped into five categories: (1) competition and financial structure; (2) deposit insurance; (3) monetary policy, central banking, and the payments system; (4) the housing finance system; and (5) the regulatory structure and international coordination.

Competition and Financial Structure

There are great public benefits from an efficient financial system that is responsive to changing consumer demands. Promoting competition is the best means to this end.

Unlike most other financial services firms, the ownership of depository firms, the activities of their affiliates and subsidiaries, and the geographic markets they can serve are restricted by law. On balance, these restrictions have been detrimental to the financial system. They are among the most important obstacles to an efficient and competitive financial system.

Eliminating barriers to the integration of banking services with other lines of business and to geographic expansion could lower the cost and improve the quality of financial services in several ways. Doing so would limit the ability of some suppliers to exercise market power. It would allow the most efficient producers, those providing the most desirable products and services at the best prices, to enter markets from which they are currently excluded. It would provide new opportunities to achieve economies of scale and scope from joint production, distribution, and information management. Finally, it would allow consumers the convenience of purchasing combinations of services from a single supplier that are now available only from separate suppliers.

Those who favor restrictions on the ownership of depository firms and the activities of their affiliates and subsidiaries cite concerns over safety and soundness, concentrations of power, abusive tie-ins, and conflicts of interest. Public policy must balance these concerns against the social costs of regulations designed to address them. Blanket restrictions on affiliations are not the best means to address such concerns. They do not contribute to financial stability and they have large efficiency costs.

Depository firms can be adequately insulated from risks posed by affiliates and subsidiaries without destroying desirable synergies in the joint production, distribution, and marketing of financial services. Indeed, present law already provides substantial insulation through tight restrictions on intercompany transactions. Our objective should not be to devise a framework in which no competitive abuses ever occur, or in which no depository firm ever fails due to activities of nonbank affiliates. Even if some abuses do occur from financial integration, consumers would still be better off, and losses to the deposit insurance agencies would still be reduced.

The potential for abusive tie-in arrangements, predatory pricing, and conflicts of interest is greatest when barriers to competition are present. Eliminating barriers to product and geographic expansion will make it less likely that such strategies can be effective. Existing antitrust laws and competitive standards provide adequate safeguards against such abuses. There is no convincing reason to have a separate and distinct competitive policy applicable to banks and other financial firms that is different from that applied under present laws to nonfinancial firms.

In sum, financial service firms, including depository firms, should be allowed to freely affiliate with other firms, including those engaging in commercial activities. The line between commercial and financial activities can be fuzzy. So long as insulating safeguards are in place, it is best to let the market determine the activities that can be profitably conducted within a single organization. For that reason, broader enforcement powers and strict penalties against noncompliance are preferable to outright prohibitions on affiliations.

Deposit Insurance Reform

The social costs of individual bank failures have been exaggerated. Historically, bank failures have not generally led to losses of confidence in the banking system. True banking panics have been rare. The chances of them occurring in the future can be minimized with sound monetary policy.

Deposit insurance was a response to the financial collapse of the 1930s. For better or worse, the public now expects its deposits to be protected by government. That commitment, however, need not be open-ended. It is widely acknowledged that deposit insurance encourages risk-taking. This problem has been exacerbated in recent years as the degree of protection has expanded. What began as a program to protect small depositors and prevent them from running has developed into a system of guarantees that regularly protects large depositors and often other creditors, managers, and shareholders of depository firms and their holding companies. As a result, the incentives of financially sophisticated investors to monitor and discipline the practices and balance sheets of depository firms have diminished. In addition, Congress and the regulators have chosen to forebear on capital standards, allowing very troubled banks and thrifts to continue operating with little or no economic capital at stake.

Under generally accepted accounting principles (GAAP), loans and investments can generally be carried at acquisition cost, or book value. Experience has shown that capital value as measured by GAAP can differ substantially from true economic value and can be manipulated to meet capital standards or to preserve the appearance of solvency. As a result, GAAP rules allow depository firms to operate with very high leverage and to survive well after their true net worth is exhausted. Although implementing market-value accounting would pose important practical problems, the distortions under GAAP are great enough that developing a workable system is warranted. If market value accounting were applied to depository firms and their subsidiaries, gains and losses would quickly show up on balance sheets, providing a powerful disincentive to adopt risky strategies. Over time, it would induce beneficial adjustments to balance sheets.

A policy of strictly enforcing capital standards based on market values will substantially enhance market discipline and reduce the cost of reorganization to the deposit insurance funds, large depositors, and other creditors. Permitting subordinated debt to fulfill part of those capital requirements has advantages. Debt-holders would be inclined toward conservative operations since they would, in effect, be "insuring" deposits up to the amount of their investment. The rating and pricing of such debt would also provide a market signal of asset quality to regulators.

When capital standards are violated, regulators should have powers to suspend interest on subordinated debt, dividends, and other payments to a parent or affiliates. In most instances, this would lead debt-holders to force timely reorganization or recapitalization. If owners of capital-impaired firms elect not to recapitalize, the deposit insurance agencies should also have the right to take them over for sale, merger, or liquidation before their capital is exhausted. These rules can safely apply to depository firms of all sizes without significant disruptions to financial markets. No bank is too big to be reorganized.

These accounting and reorganization rules differ substantially from those that apply to nondepository firms. Deposit insurance justifies stringent standards. With such rules in place, permissible activities for depository firms could be expanded. Indeed, organizations could be granted greater latitude in determining where to locate activities within the corporate structure based on the accounting and reorganization rules that apply to depository firms and their subsidiaries as compared with their nondepository affiliates.

In sum, deposit insurance was intended to protect small depositors and to support a stable financial structure, not to protect all individuals and firms from loss. The more regulators rely on meaningful capital standards and prompt reorganization of capital-impaired depository firms, the less regulation is needed to protect the deposit insurance funds. Greater freedom from regulation would, in turn, contribute to a more efficient, adaptable, and safe financial system.

Monetary Policy, Central Banking, and the Payments System

To a great extent, the safety and soundness of the financial system depends on factors beyond the control of financial intermediaries, either individually or as a class. A basic prerequisite for financial stability is macroeconomic stability, in particular, price stability. This requires sound monetary policy focused on limiting the growth of the monetary base over time. Price level instability induces interest rate instability and distorts perceptions of credit risk. The rising number of failed and weakened depository firms in recent years is, in part, a result of the cycle of inflation and disinflation and the accompanying volatility of interest rates, asset values, and real returns that began in the 1970s. Historically, both in the U.S. and elsewhere, periods of price level instability have been accompanied by high rates of bank failures.

Monetary policy to achieve macroeconomic stability can be conducted without supporting financial market regulations. Open market operations are a necessary and sufficient policy instrument. A related responsibility of the Federal Reserve is to provide liquidity during financial crises in order to limit the effects of financial failures to insolvent firms. Open market operations are also sufficient to stabilize markets when a financial crisis develops.

In addition to its monetary responsibilities, the Federal Reserve regulates, supervises, and conducts a wide range of operations with depository firms. These activities, which include discount window lending, payments system operations, and establishing reserve requirements, can be termed banking policies. The banking policies of the Federal Reserve cannot be readily justified in terms of macroeconomic benefits. Reserve requirements, in particular, are unnecessary for the conduct of monetary policy.

Today's financial markets are highly efficient in allocating credit privately. The Federal Reserve discount window is a public line of credit service that is similar in many respects to private lines of credit. The discount window functions most importantly as a source of emergency credit assistance to banks that the Federal Reserve perceives to be illiquid, but solvent. The Federal Reserve faces the same problem as private lenders in distinguishing insolvent from illiquid banks. There is little reason to believe that it is superior to private lenders in determining the solvency of potential borrowers. Under normal circumstances, discount window lending, collateralized by Treasury securities, involves minimal subsidies. A potentially larger implicit subsidy arises from the Federal Reserve's discretionary power to lend on less than perfect collateral. The availability of this public line of credit may have hidden economic costs. It may encourage some forms of risk-taking, and lead to the erosion of private arrangements for liquidity. For these reasons it is difficult to justify routine discount window lending as an appropriate government intervention.

Responsibility for preserving financial stability has also come to include protecting the payments system. Rapid growth in the volume of payments and an expansion in the range of firms that have access to the payments system, either directly or through affiliates, has raised new concerns. The main risks are associated with the electronic transfer systems, the operation of which currently involves substantial intraday credit, or "daylight overdrafts."

The risk exposure from daylight overdrafts to payments system participants is no different from other types of credit exposure. Safe and sound management involves monitoring and limiting exposures. Historically, however, overdrafts have not been carefully monitored, and incentives to limit overdrafts remain small. If overdrafts bore a market rate of interest, their volume would shrink and lenders would be compensated for the risk they bear. There are a variety of ways in which an intraday market for federal funds can be encouraged. In addition, regulatory changes, such as substituting term federal funds for overnight funds, would substantially reduce their volume. With these changes, payments system risks can be reduced to tolerable levels.

The goal of protecting the payments system does not justify limitations on affiliations. Daylight overdrafts granted to nonbank affiliates of banks should be subject to the same restrictions as other extensions of credit by a bank to its affiliate.

Daylight overdrafts over Fedwire create analogous problems to those of discount window lending. These mechanisms for extending credit justify Federal Reserve regulation and supervision in the same way that private suppliers of credit monitor and supervise borrowers to protect their funds. If discount window lending and daylight overdrafts on Fedwire were substantially curtailed, the costly regulatory and supervisory responsibilities of the Federal Reserve could also potentially be curtailed. A thorough review of Federal Reserve banking policies is necessary to explore these issues further.

The Housing Finance System

The federal government is extensively involved in the operation and regulation of the housing finance system through the Federal Home Loan Bank system and the federally-sponsored secondary mortgage market agencies. The evidence indicates that these institutions have not channeled resources into housing to any great extent since the 1950s.

A separate institutional framework to provide preferential treatment for housing finance is becoming increasingly anachronistic. Moreover, it is now unraveling under the pressures of inflation and technological change. As S&Ls have been granted broader asset and liability powers, housing finance has become less important to them. In turn, as alternative sources of mortgage finance have emerged, S&Ls have become less important to housing finance. The S&Ls' role in housing finance no longer justifies the regulatory advantages they have, if it ever did.

In today's financial markets, there is little public policy justification for government agencies to function as mortgage lenders, securities issuers, and secondary market-makers in competition with private firms. Over time, FNMA and Freddie Mac should be privatized. There are a variety of ways government involvement can be wound down.

The recent FSLIC recapitalization is totally inadequate. Congress will soon be forced to address this problem again. Merging the FSLIC with the FDIC will not be an adequate solution to the problem. Ultimately, taxpayers will bear most of the cost. Forbearance and leniency will lead to a further deterioration in the FSLIC's situation as insolvent firms continue to pursue go-for-broke strategies. For that reason, every effort should be made to close insolvent firms as quickly as possible.

The Regulatory Structure and International Coordination

Competition in financial services is taking place not only among private firms, but also among overlapping regulatory systems both nationally and internationally.

The effects of regulatory competition have been healthy on balance within the U.S., and can be healthy world-wide, but it can also have undesirable dimensions to be guarded against. It is beneficial when regulators are pressed into establishing a regulatory climate in which financial services can be efficiently and safely provided. Regulatory competition reduces the risk of adopting narrow and inflexible approaches to problems, fosters experimentation, and facilitates timely and efficient adaption to changing market conditions. Just as private firms routinely face potential conflicts of interest, so do financial regulators who not only represent the public interest, but who also have incentives to maximize their own jurisdiction and authority. Regulatory competition helps to resolve these incentive conflicts.

Regulators can also compete by providing hidden subsidies. The most significant subsidies come from implicit or explicit protections extended to financial firms through deposit insurance, the discount window, the payments system, and other mechanisms governments may use to bail-out private financial firms. As noted earlier, these protections create incentives for financial firms to take on greater risk. Over time, they can undermine financial stability. Clearly, this type of competition is undesirable. The costs and risks of such policies must be made transparent to taxpayers. This requires fundamental reporting and accounting reforms, and clearly defined rules governing reorganizations of capital-impaired firms.

Although efforts to achieve greater international coordination of regulatory policies are well-intended, the potential problems with coordination are illustrated by the recent efforts to achieve an international agreement establishing uniform risk-based capital standards. This plan is subject to major flaws. It would be undesirable for it to become a uniform international standard at this stage.

In sum, for regulatory reform to have a lasting positive effect, it must deal constructively with the highly competitive environment within which both financial firms and their regulators operate. It can best do so by improving incentive structures and information systems applying to both private firms and their regulators.

The **Chairman**. Thank you very much, gentlemen, for two excellent statements.

Mr. Litan, you say on page 2 of your testimony that consumers won't directly benefit from removal of Glass-Steagall barriers as provided in S. 1886.

Aren't you reading the word "consumer" too narrowly? After all, corportions, towns, cities, States, home builders, buyers are all consumers of bank services and will benefit from removal of Glass-Steagall barriers. Isn't that true?

Mr. **Litan**. Yes.

We all benefit when Glass-Steagall barriers are removed, and I don't want to give the misimpression that the entities that you talked about wouldn't benefit. Clearly, they will benefit.

I guess my basic point is that the average guy on the street doesn't see these benefits as squarely as he would if bank holding companies were allowed into insurance and real estate because he directly buys those services. Consumers now directly buy brokerage services from securities houses, but as you know, bank holding companies now don't offer insurance or real estate brokerage.

The **Chairman**. Mr. Haraf, would you comment on the postion Mr. Litan has taken?

Do you agree or disagree, or would you modify it?

Mr. **Haraf**. I think there would be substantial consumer benefits associated with breaking down Glass-Steagall barriers. They arise through a number of channels. Competition would be encouraged, not only among the larger banks and investment houses, but also among community bankers. As banks get involved in providing securities services I think consumers will see real benefits and they will see them in a variety of ways.

The **Chairman**. Mr. Haraf, Mr. Litan on page 5 of his testimony commented on the existing security powers of banks. Here is what he said:

> If the committee is interested in minimizing risk to the bank, I think a cleaner break would require all municipal underwritings, general obligation and revenue bonds to be carried out in the securities affiliates, leaving banks to underwrite directly only Federal securities.

The SEC will testify tomorrow in favor of a similar approach.

As you might have noticed, the Treasury Secretary Gould was opposed to that.

What do you think of Mr. Litan's and the SEC's suggestion on that?

Mr. **Haraf**. Well, Senator, I really don't have any strong feelings about this, and I can't claim to have studied the risk aspects of underwriting municipal securities as compared with Federal securities very closely. But my presumption is that it would not be necessary to move in that direction.

The **Chairman**. It would not be necessary because of the safety and soundness problems?

Mr. **Haraf**. That is right.

My judgment is that underwriting municipal revenue securities is not a very risky activity and would not substantially place the deposit insurance funds at risk.

The **Chairman**. Mr. Litan, as you know, banks have been underwriting general obligation bonds without any real problem.

SAFETY OF REVENUE BONDS

It has been my view, although some people contest it, that revenue bonds are, if anything, safer. Maybe not, but they are certainly of comparable safety.

So why? Is it just a matter of symmetry, or is there some other reason?

Mr. LITAN. Basically, symmetry and cleanliness.

The CHAIRMAN. I am all for that. [Laughter.]

Mr. LITAN. Under your proposal, as I understand it, all municipals will go in the bank and all corporates would go in the affiliate.

But, if you compare these two classes of securities, the underwriting, I don't see that there's much difference in the risk between the two.

So, therefore——

The CHAIRMAN. Say that again? You don't see much difference?

Mr. LITAN. Between the municipals as a class and corporates as a class.

The CHAIRMAN. And corporates as a class?

Mr. LITAN. That's right. And why put one inside the bank and why put one outside?

The CHAIRMAN. I'm surprised at that. I would think, in a recession, corporate underwriting would be riskier.

Mr. LITAN. As a practical matter, underwriting periods are generally a day or two.

The CHAIRMAN. I realize it's a very short time.

Mr. LITAN. In fact, as a general rule, the municipal market is not as liquid a market as the corporate market is.

Thus, you could even argue that municipal underwriting is riskier because of the difference in the liquidity of the markets.

But the point I was referring to in my written testimony——

The CHAIRMAN. Let me just get back a minute to the timing factor.

Isn't it possible that an underwriter would have to carry the securities underwritings sometimes in his inventory for a period of time?

Mr. LITAN. Yes. Absolutely.

The CHAIRMAN. Would it be possible under the circumstances that he could take a substantial loss?

Mr. LITAN. With both municipals and corporates. And if he——

The CHAIRMAN. The municipal bond, by and large, has been safe except of course if interest rates vary, then the value of the securities may drop. But, in corporate securities, it seems to me, they are more subject to insolvency. They don't have that ultimate taxing power that municipalities have.

Mr. LITAN. That's true, but I don't think the ultimate taxing power makes much difference in the underwriting period you're talking about.

The CHAIRMAN. But it would make a difference in the inventory period.

Mr. LITAN. Even in the inventory period, I think the periods are short enough so that the risk between the two securities is virtually indistinguishable. Therefore, I'm just pointing out from the symmetry point of view that both municipals and corporates ought to belong in the same place.

Now, if they belong in the same place, the question is which place should it be. Should it be the affiliate or should it be the bank?

My point in my testimony is: If you compare municipals and corporates on the one hand versus Treasury's on the other, I think you have to conclude that Treasury underwriting is on balance less risky than municipals and corporates as a group.

Therefore, I was just making the symmetrical point:

Why not put everything together in one place?

I don't have any overwhelming objection though to adopting the approach you've talked about, which is to go ahead and put all municipals inside the bank. I was just making a symmetry point based on what the evidence of underwriting risk is, or I know it to be.

The CHAIRMAN. Do you have any comment, Mr. Haraf?

Mr. HARAF. In each of these cases, what's relevant is the magnitude of the exposure in relation to the bank's capital. My view is that these underwriting activities are substantially less risky, generally, than direct lending.

Of course, prudence dictates that any exposure be manageable within the context of the bank's own capital. It seems to me that's the standard which should be applied.

The CHAIRMAN. Mr. Litan, Mr. Haraf on page 3 of his testimony discusses whether securities power should be exercised in a subsidiary of a bank or affiliate of a holding company.

He says: "I'm not aware of any evidence that bank holding companies which form securities subsidiaries abroad run into trouble from intracompany transactions."

Do most banks exercising securities powers abroad do it in the subsidiary of the bank or the affiliate of a holding company?

And are you aware of whether any of these banks have run into problems in exercising these powers?

Mr. LITAN. To my knowledge, the American banks that now underwrite abroad do it through affiliates. That is, subsidiaries of a holding company, not directly out of the bank. That's to my knowledge.

Again, the evidence I'm familiar with suggests that there will be no problems.

The CHAIRMAN. They've had no problems?

Mr. LITAN. No.

The CHAIRMAN. Would you agree, Mr. Haraf?

Mr. HARAF. Yes.

The CHAIRMAN. Senator Karnes.

Senator KARNES. Mr. Chairman, I would just like to apologize for my absence. I've been involved in Farm Credit legislation and will be doing so for the rest of the afternoon, probably.

But I have no questions other than just trying to squeeze some time in here to follow this very important piece of legislation. I have great interest in it, and I apologize to the people that are speaking here today for my coming in late.

The CHAIRMAN. Thank you, Senator Karnes.

Mr. Haraf, you say in your testimony that barriers to entry should be the concern of those who want to encourage competition.

First, Glass-Steagall keeps banks out of investment banking. Someone called this an entry problem. Do you agree?

Mr. HARAF. Yes, I do.

PROLONGED PREDATORY PRICING

The CHAIRMAN. Is not the so-called "deep pocket"— that is, the ability of large firms—to engage in prolonged predatory pricing a deterrent to entry?

Mr. HARAF. Senator, that largely depends on whether or not there are significant costs to entry into these particular markets, and whether or not financial firms have market power under existing conditions.

My judgment is, that if Glass-Steagall and similar types of barriers are removed, the costs associated with entry into the securities business or into the banking business would be low enough that predatory pricing strategies would not generally make sense— even for a firm with very deep pockets.

The CHAIRMAN. But the way I understand that predatory pricing works, it doesn't necessarily mean that you operate at a profit. You operate in a way that would discourage your competition.

And we see on the basis of our experience, we see securities underwriting industry which has been highly concentrated.

I'm not saying they've engaged in anything illegal, immoral or whatever, but there is that possibility. And prohibiting combinations of large firms would serve the goal of reducing a barrier to entry, would it not?

Mr. HARAF. Yes, that's right. I agree with that, Senator. I thought you were making a different point.

The argument, as I understand it, about predatory pricing says that a firm with market power might subsidize some particular activity over some length of time to drive competitors out of the business, at which point the firm would then raise its prices and reap monopoly profits.

The question is whether or not that's a useful strategy in this industry. It seems to me it's a useful strategy only if it's not possible for those competitors, or new competitors to get back into the business once the predatory firm raises its prices again.

In my view, a strategy of successful predatory pricing depends on the costs of entry. And I judge those costs to be relatively low in most of these financial activities.

The CHAIRMAN. Gentlemen, I want to thank you very much. You're both highly esteemed scholars. You've done an excellent job and we very much appreciate your statements.

The committee will stand in recess.

[Whereupon, at 12:10 p.m., the committee adjourned.]

[Additional material supplied for the record follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Burton C. Wood
Senior Staff Vice President
and Legislative Counsel
202-861-6507

December 10, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

This letter is submitted with respect to hearings the Senate Banking Committee has been conducting throughout the 1st Session of the 100th Congress (most recently during the first two weeks of December) pertaining to expanded powers for bank holding companies. The Mortgage Bankers Association of America respectfully requests that this letter be included in the official Committee hearing record.

MBA supports those provisions in S 1886, the "Financial Modernization Act of 1987," co-introduced by you and Senator Jake Garn (R-UT), Ranking Minority Member of the Senate Banking Commitee, that would grant bank holding company affiliates expanded securities powers. In particular, MBA strongly supports the authorization of these financial institutions to underwrite and deal in privately issued mortgage-backed securities (MBSs).

The growth of the private secondary mortgage market is particularly important in light of ongoing initiatives of the Administration that focus on reducing the role of the federally sponsored mortgage credit entities, such as the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC), in the capital markets. Fortunately, the importance of improving the flow of funds to the housing sector has been recognized by Congress, which has encouraged the growth of the secondary mortgage market. While the programs offered by these federally sponsored entities are an important element in enhancing homeownership affordability, there remains a vital need for more entrants into the private MBS marketplace.

Bank and thrift institutions are currently able to underwrite and deal in MBSs guaranteed by the federally sponsored entities. U.S. banks may also underwrite privately issued securities abroad and are leaders in the Eurobond markets. Ironically, what they can do under current law is somewhat inconsistent with what they cannot do. It is paradoxical that banks can underwrite bonds to support public housing and dormitories for college students, yet they are precluded from underwriting privately issued MBSs to help finance housing for low- and moderate-income families. Also, a bank may purchase whole loans from an originator, then issue and underwrite its own MBS collateralized by those mortgages, but if the originator itself issued the identical MBS collateralized by those same mortgage loans, then the bank would be prohibited from underwriting the offering.

Another troublesome aspect of today's secondary mortgage market is that the underwriting of privately issued MBSs is exceptionally concentrated in the hands of relatively few investment banking firms. Because of this high level of concentration, these firms are able to set underwriting fees unilaterally with little, if any, price competition. Permitting bank holding company affiliates to underwrite privately issued MBSs would significantly increase the number of competitors in the marketplace, thereby leading to lower underwriting costs and more investors at the local or regional level. This would create greater liquidity for the secondary mortgage market and lower interest rates for homebuyers. The increased number of participants underwriting MBSs, both on local and national levels, would help ensure that mortgage credit is available in all parts of the country, thus increasing the availability as well as the affordability of mortgage credit.

While MBA believes the expansion of the type and number of institutions participating in the secondary mortgage market will benefit the housing and financial markets in general, we urge the Committee to ensure that there will be appropriate safeguards to protect federally insured depository institutions against certain risks associated with underwriting activities. As found in S 1886, one possible safeguard could be to require that underwriting activities be conducted by a holding company subsidiary separate and apart from the depository institution subsidiary to ensure that underwriting activities would not adversely affect federally insured deposits. MBA believes the strength and integrity of financial markets and institutions are of paramount importance to the housing industry and to the economy.

In discussing risks associated with underwriting MBSs, a great deal of recent publicity has surrounded large losses suffered in MBS transactions. These losses, however, resulted not so much from underwriting activities as from poorly controlled positions in the market. Also in the past, large losses were reported by Bank of America in 1984 and by a number of investors in 1985 as a result of the collapse of Equity Programs Investment Corp (EPIC). These were isolated incidents where fraud and misrepresentation, particularly in the appraisals of the underlying properties, played a leading role. The Committee should not view these losses as indicative of normal risks associated with underwriting MBSs.

While the dollar volume of private issues is small compared to that of issues backed by GNMA, FNMA, and FHLMC, the private market has significant growth potential. Market expansion is being stimulated by innovations in market instruments, private sector conduit issuers, and the globalization of the capital markets as evidenced by the attraction of European and Asian investors to MBSs. Congress has contributed to this growth potential with the enactment of the Secondary Mortgage Market Enhancement Act of 1984 (P.L. 98-440) and with the inclusion of the Real Estate Mortgage Investment Conduit (REMIC) provisions in the Tax Reform Act of 1986 (P.L. 99-514). Legislative initiatives such as these will broaden the secondary mortgage market and increase the liquidity of MBSs, while lowering mortgage interest rates for homebuyers. In light of recent Congressional activity in this area, MBA respectfully urges Congress to continue its support for housing and the secondary mortgage marketplace by enacting legislation that would allow bank holding company affiliates to underwrite and deal in MBSs.

We would be pleased to furnish any additional needed information to you and Members of the Committee. Thank you for your courtesy in this matter.

Sincerely,

Burton C. Wood

Burton C. Wood

LEGISLATIVE PROPOSALS TO RESTRUCTURE OUR FINANCIAL SYSTEM

THURSDAY, DECEMBER 3, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Graham, Garn, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. This morning we continue our hearings on financial restructuring. Today we will hear testimony from three witnesses who will give us the regulators' perspective on the three proposals before the committee.

We will go alphabetically starting with Mr. Clarke, the Comptroller of the Currency; and then Mr. Ruder, Chairman of the Securities and Exchange Commission; and finally Mr. Seidman, who is the head of the Federal Deposit Insurance Corporation.

We have before the committee three serious legislative proposals, S. 1886, introduced by Senator Garn and myself; S. 1891, introduced by Senators Graham and Wirth; and S. 1905, introduced by Senators Cranston and D'Amato.

I would hope that the witnesses would give thorough consideration to the strengths and weaknesses of each of these proposals in their testimony today.

Having three concrete proposals before the committee is tangible evidence of the serious efforts that members and their staffs are putting forth to meet our responsibility of enacting legislation before the expiration of the moratorium in March 1988.

Legislation to modernize our financial structure is long overdue. Glass-Steagall provisions separating commercial banks from investment banks are inhibiting competition that would drive down the cost of capital for American business, and capital formation is vital to the health and well-being of our economy.

We no longer live in a world dominated by American business enterprise. Competition from other countries in the industrial world and from developing countries pose a great challenge to American business. We must do everything we can to help to keep their costs down. In essence, maintaining entry barriers in the underwriting business just to protect the investment banking industry is a luxury our economy can no longer afford.

Senator Dixon.

OPENING REMARKS OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I'm going to put most of my statement in the record, but I think for the record I'd just like to read the last two paragraphs which I think capsulize the views of this Senator regarding what we're trying to do here.

I am confident the Banking Committee can produce a good bill by next March 1. I think it's vital, however, that we craft legislation that has a real chance to be enacted. There are some signs that the attitude in the House may not be as hostile to reform as it has been in the past. I think there's a real chance to enact a bill that takes a major step in updating our banking laws if we don't try to over-reach what's achievable.

I think we should press the House hard. At the same time, we should not try to overwhelm the other body with a bill that they would feel they would not have the time to adequately consider in the time available to them next year.

I look forward to working with my colleagues on the committee in crafting legislation that will make it completely through the legislative bodies.

Thank you, Mr. Chairman. I would like to put my whole statement in the record.

The CHAIRMAN. Well, it's a great statement.

Senator DIXON. Well, I'd be glad to read it all if you're so overwhelmed.

The CHAIRMAN. No, I just want you to read the part you read again. [Laughter.]

I also have statements of Senators D'Amato and Karnes that without objection will be inserted in the record.

DECEMBER 3, 1987

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
BANKING INDUSTRY REFORM LEGISLATION

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE BANKING COMMITTEE CONTINUES ITS HEARINGS ON THE MAJOR BANKING REFORM LEGISLATIVE PROPOSALS NOW BEFORE US.

THE BANKING COMMITTEE HAS ACTED TO EXPAND THE ASSET POWERS AVAILABLE TO BANKING ORGANIZATIONS AT LEAST THREE TIMES IN THE LAST 20 YEARS. MOST RECENTLY, IN 1984, THE COMMITTEE REPORTED LEGISLATION GIVING BANKING ORGANIZATIONS REVENUE BOND, MORTGAGE BOND, AND COMMERCIAL PAPER UNDERWRITING AUTHORITY. THE FULL SENATE PASSED THIS LEGISLATION BY A HUGE 89 TO 5 VOTE.

BANK HOLDING COMPANIES, HOWEVER, STILL DO NOT HAVE THIS AUTHORITY. IT IS IMPORTANT TO KEEP THIS HISTORY IN MIND AS THE COMMITTEE WORKS TO REPORT REFORM LEGISLATION BEFORE THE MARCH 1, 1988 EXPIRATION OF THE MORATORIUM. THE HOUSE OF REPRESENTATIVES HAS NOT BEEN VERY FERTILE GROUND FOR BANKING INDUSTRY REFORM LEGISLATION IN THE LAST 20 YEARS. IT KILLED THE SENATE-PASSED INITIATIVES EACH TIME.

I AM CONFIDENT THAT THE BANKING COMMITTEE CAN PRODUCE A GOOD BILL BY NEXT MARCH 1ST. I THINK IT IS VITAL, HOWEVER, THAT WE CRAFT LEGISLATION THAT HAS A REAL CHANCE TO BE ENACTED. THERE ARE SOME SIGNS THAT THE ATTITUDE IN THE HOUSE MAY NOT BE AS HOSTILE TO REFORM AS IT HAS BEEN IN THE PAST. I THINK THERE IS A REAL CHANCE TO ENACT A BILL THAT TAKES A MAJOR STEP IN UPDATING OUR BANKING LAWS IF WE DO NOT TRY TO OVERREACH WHAT IS ACHIEVABLE.

I THINK WE SHOULD PRESS THE HOUSE HARD. AT THE SAME TIME, WE SHOULD NOT TRY TO OVERWHELM THE OTHER BODY WITH A BILL THAT THEY WOULD FEEL THEY WOULD NOT HAVE THE TIME TO ADEQUATELY CONSIDER IN

THE TIME AVAILABLE TO THEM NEXT YEAR. I LOOK FORWARD TO WORKING WITH MY COLLEAGUES ON THE COMMITTEE IN CRAFTING LEGISLATION THAT WILL MAKE IT COMPLETELY THROUGH THE LEGISLATIVE MAZE.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

DECEMBER 3, 1987

THIS MORNING WE CONTINUE THE TASK OF REVIEWING THE VARIOUS LEGISLATIVE PROPOSALS THAT MUST PROVIDE THE VEHICLES FOR TRULY COMPREHENSIVE REFORM OF OUR FINANCIAL SERVICES INDUSTRY. TO SUCCEED IN THE REFORMATION OR RESTRUCTURING OF THE FINANCIAL SERVICES INDUSTRY, WE MUST BE CAREFUL THAT WE DO NOT ENACT LEGISLATION THAT PROVIDES BUILT-IN COMPETITIVE ADVANTAGES FOR ONE PARTICIPANT IN THIS INDUSTRY OVER THE OTHERS.

SENATOR CRANSTON AND I INTRODUCED THE DEPOSITORY INSTITUTION AFFILIATION ACT BECAUSE WE BELIEVE THAT IT REPRESENTS TRUE FINANCIAL REFORM BECAUSE IT ALLOWS ALL THOSE WISHING TO ENTER THE FINANCIAL SERVICES INDUSTRY TO COMPETE WITH EXISTING PARTICIPANTS ON AN EQUAL FOOTING.

IN THE PAST, FEDERAL BANKING REGULATORS, ESPECIALLY COMPTROLLER CLARKE HAVE WARNED US THAT: "CHANGES IN FINANCIAL MARKETS HAVE ERODED THE DISTINCTIONS AMONG FINANCIAL INSTITUTIONS AND INTRODUCED NEW RISKS AND UNCERTAINTY INTO THE FINANCIAL SYSTEM." THESE CHANGES PROMPTED SENATOR CRANSTON AND I TO INTRODUCE LEGISLATION THAT RECOGNIZES THE NEED FOR A TOTAL REEVALUATION OF THE STATUTORY FRAMEWORK.

THE DEPOSITORY INSTITUTION AFFILIATION ACT CREATES A STATUTORY FRAMEWORK THAT PROVIDES EXISTING AND POTENTIAL PARTICIPANTS IN THE FINANCIAL SERVICES INDUSTRY THE OPPORTUNITY TO EVOLVE WITH MARKET CONDITIONS AND COMPETE IN TODAY'S ECONOMIC ENVIRONMENT AND, AT THE SAME TIME, ENHANCE THE SAFETY AND SOUNDNESS OF THE FINANCIAL SYSTEM. IF WE DO NOT ENACT A TRULY COMPREHENSIVE REFORM PACKAGE SUCH AS THE DEPOSITORY INSTITUTION AFFILIATION

ACT, THIS COMMITTEE SHOULD EXPECT TO BE CONFRONTED WITH THE SAME DILEMMA IN SEVERAL YEARS THAT IT CURRENTLY FACES TODAY. IN AN EFFORT TO RIGHT THE COMPETITIVE INEQUITIES BETWEEN PLAYERS IN THE FINANCIAL SERVICES INDUSTRY CREATED BY THE COMPETITIVE EQUALITY BANKING ACT AND LEGISLATION WHICH GRANTS BANKS A FEW SECURITIES POWERS, LOOPHOLE LAWYERS IN THE PUBLIC AND PRIVATE SECTORS WILL BEGIN TO LOOK FOR WAYS TO BLUR THE LINES BETWEEN COMMERCE AND BANKING. RATHER THAN LEAVE SUCH DECISIONS TO THE WHIM AND FANCY OF THE FEDERAL REGULATORS, THE CONGRESS SHOULD PROVIDE A COMPLETE AND WORKABLE FRAMEWORK.

IN A FEW YEARS WE'LL BE HEARING THAT THE BANKING AND SECURITIES INDUSTRIES NEED ADDITIONAL AND NEW SOURCES OF CAPITAL. GRANTING BANKS A FEW NEW POWERS WILL NOT RESULT IN OPENING UP THE FLOODGATES OF CAPITAL THAT HAVE BEEN DAMMED UP BEHIND THE GLASS-STEAGALL WALL FOR 54 YEARS. THE GRANT OF A FEW SECURITIES POWERS TO BANKS WILL ONLY INCREASE THE NUMBER OF PLAYERS IN THOSE MARKETS. IT WILL NOT INCREASE THE SIZE OF THOSE MARKETS. THEREFORE, THE ADDITIONAL SOURCES OF CAPITAL AND REVENUE PROVIDED BY A FEW NEW POWERS WILL BE QUITE LIMITED IF NOT TOTALLY ILLUSORY.

FINALLY, IN OUR EFFORTS TO REFORM THE FINANCIAL SERVICES INDUSTRY, WE SHOULD EXAMINE THE STATUTORY FRAMEWORK THAT MIGHT EXIST IF THE PROVISIONS OF THE FINANCIAL MODERNIZATION ACT (FMA) ARE COMBINED WITH THE NON-BANK BANK PROVISIONS OF THE COMPETITIVE EQUALITY BANKING ACT (CEBA). WITH THE EXCEPTIONS OF THE SAFEGUARDS PROVIDED BY THE FEDERAL RESERVE ACT AND THE FEDERAL SECURITIES LAWS, THE COMBINATION OF CEBA WITH FMA WILL LEAVE THE STATUTORY FRAMEWORK SOMEWHAT SIMILAR TO THAT WHICH EXISTED BEFORE 1933. RATHER THAN UNDERTAKE A NOSTALGIC LOOK BACKWARD TO PRE-DEPRESSION AMERICA, I BELIEVE THAT WE SHOULD LOOK FORWARD TO THE 21ST CENTURY WHICH WILL SOON BE

UPON US. I COMMEND FDIC CHAIRMAN SEIDMAN FOR THE FORWARD LOOKING PROPOSALS CONTAINED IN THE FDIC'S STUDY ENTITLED: MANDATE FOR CHANGE.

FINALLY, I AGREE WITH MUCH OF SEC CHAIRMAN RUDER'S TESTIMONY REGARDING THE SAFEGUARDS THAT MUST BE MAINTAINED AND PERHAPS ENHANCED AS WE MOVE TOWARD A COMPREHENSIVE REFORM OF OUR FINANCIAL SERVICES INDUSTRY.

AS CHAIRMAN RUDER NOTES THESE POLICIES ARE ACCOMPLISHED BY A REGULATORY SCHEME THAT INCLUDES:

(1) FULL AND FAIR DISCLOSURE IN THE PURCHASE AND SALE OF SECURITIES;

(2) REGISTRATION AND REGULATION OF ALL BROKER-DEALER ACTIVITY; AND

(3) PROTECTION AGAINST CONFLICTS OF INTEREST AND DISHONEST PRACTICES IN THE SALE AND MANAGEMENT OF PROFESSIONALLY MANAGED POOLS OF CAPITAL.

THE DEPOSITORY INSTITUTION AFFILIATION ACT HOPEFULLY SATISFIES CHAIRMAN RUDER'S CONCERNS.

I LOOK FORWARD TO THE TESTIMONY OF THIS MORNING'S WITNESSES AND WORKING WITH THEM TO ACHIEVE A TRULY COMPREHENSIVE AND MODERN REGULATORY FRAMEWORK.

OPENING STATEMENT:

SENATOR DAVID KARNES

DECEMBER 3, 1987 HEARING ON S. 1886 AND S. 1891

MR. CHAIRMAN. I WANT TO TAKE THIS OPPORTUNITY TO COMPLIMENT YOU ON YOUR EFFORTS TO KEEP THE DIALOGUE MOVING ON THE WHOLE ISSUE OF FINANCIAL REFORM. I ALSO WANT TO THANK THE DISTINGUISHED PANEL ASSEMBLED TO TESTIFY ON THIS VERY IMPORTANT ISSUE.

THE ACTIVE INVOLVEMENT OF CHAIRMAN SEIDMAN AND COMPTROLLER CLARKE, THE TWO LARGEST REGULATORS OF OUR FINANCIAL INSTITUTIONS, IS PARTICULARLY IMPRESSIVE. THEIR THOUGHTFUL ARGUMENT ON THE NEED FOR FINANCIAL REFORM AND EXPANDED POWERS LENDS PARTICULAR CREDIBILITY TO THE ENTIRE ISSUE. I APPRECIATE THEIR PARTICIPATION IN THE PROCESS AND LOOK FORWARD TO CONTINUING TO WORK WITH ALL OF THE DISTINGUISHED PANEL MEMBERS AS WE PROCEED. THANK YOU.

David K. Karnes

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I commend you for having such a distinguished panel here. We've got all three of these people together today. I'm an old businessman of 35 years. I have to ask the question: Who's minding the store today? [Laughter.]

I'll be anxious to hear from all of you.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you, Mr. Chairman. I just want to join in welcoming this distinguished panel before us today. I have already said what I have to say and look forward to hearing what the experts have to say.

The CHAIRMAN. Thank you, gentlemen.

Mr. Clarke, go right ahead, sir.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Mr. Chairman and members of the committee, I appreciate the opportunity this morning to address reform of the Glass-Steagall Act.

An English cynic once wrote: "A committee is a cul-de-sac down which ideas are lured and then quietly strangled." [Laughter.]

The CHAIRMAN. You're looking at the right committee for that. [Laughter.]

Mr. CLARKE. He obviously never made the acquaintance of the Senate Banking Committee. The fact that we are here today is proof that—when it comes to ideas—this committee is in the business of nurturing, not murdering.

It is clear that a broadly based consensus on the need for some kind of Glass-Steagall reform is developing. Significant contributions have come from you, Mr. Chairman, and Senator Garn, other members of this committee and the Congress, the administration, my fellow bank regulators, the academic community and the financial services industry.

It is important that we recognize areas of broad agreement in the bills introduced by members of this committee and in a proposal that I will discuss today. We agree on why reform is needed. We agree that reform must be coupled with insulating commercial banks from the risks of new activities to properly restrict the availability of the safety net provided by federally insured deposits. And most important, we agree that reform will yield a more competitive financial services industry, thus benefiting all consumers of financial services.

Mr. Chairman, I have a written statement for the record that addresses the need for reform of the Glass-Steagall Act, outlines some ideas for a structural framework that I think should replace it, and makes observations about some of the bills that have been introduced.

STRUCTURAL FRAMEWORK

Rather than attempt to summarize my written statement in its entirety, I would like to concentrate this morning on my ideas about a structural framework.

Before doing so, I must note that despite any difference in approach that those of us testifying before you may have, we must not lose sight of the real issue here—that banks must be allowed greater freedom to compete.

My suggestions for a structural framework are really just variations on the basic theme of S. 1886 and the other proposals. They are based on the principle of corporate separateness. They are directed toward preserving the safety and soundness of financial institutions, ensuring that conflicts of interest are not resolved to the detriment of the public, and maintaining a fully competitive financial services marketplace.

In addition, my suggestions for a structural framework would permit banks to choose from among several forms of corporate separateness and would rely, with a few exceptions, on existing safeguards, rather than on extensive new layers of statutory protection. This approach is a simple one: in addition to some of the other structures that have been proposed, give banks the option of conducting securities activities through subsidiaries of the bank itself.

Mr. Chairman, you have previously been subjected to my views on this subject, but because I believe so strongly that there is an opportunity here to improve the competitiveness of banking—and particularly of smaller institutions—I would like to air my views before the entire committee.

The key to a more competitive financial services industry is the removal of barriers to the kinds of businesses with which banks may affiliate. Affiliation would have as its cornerstone a form of separate incorporation that would serve to insulate the bank from the affiliate.

There are a number of forms of affiliation that involve separate incorporation, including affiliations through a holding company, joint ventures that are owned by more than one bank, or wholly owned subsidiaries of banks. All deserve consideration. No one form of organization brings with it any clearly demonstrated superiority over the other.

In fact, I see no reason to force any particular form of affiliation on the private sector. Banks should have the freedom to choose. And having chosen, their activities should be regulated and supervised in the same way and subject to exactly the same rules, regardless of where they are placed. This freedom to choose would particularly enhance the ability of smaller banks to reap the benefits of deregulation.

Unlike other proposals that would require that securities activities be restricted to a subsidiary of a bank holding company, our proposal is simply to require legal separation, not a particular form of affiliation. This leaves open the possibility that a bank could place the activities in a wholly owned subsidiary—a simpler and less expensive option than forming a new bank holding company. This is important because approximately one-third of all commercial banks today are not affiliated with bank holding companies. These banks are generally smaller community banks. The freedom to choose the most appropriate form of organization in the event of product deregulation would thus increase the number of options

available to these institutions, which
wide.

S. 1886 would streamline the holdi
ess for these banks, and I support t
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Mr. Chairman, I would like to tou
morning—the area of safeguards. We
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To summarize my position: Mr. Ch
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choose from among a variety of busi
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The means for controlling those ris
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financial services, we may inadverten
reform of the Glass-Steagall Act can
financial services marketplace.

In conclusion, Mr. Chairman, I w
and the other members of this comm
nancial reform and to express my pe
any way that can be helpful.

I would be pleased to respond to an

[The complete prepared statement

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rsonal desire to assist you in

questions.
of Robert L. Clarke follows:]

For release upon delivery
December 3, 1987

STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
December 3, 1987

INTRODUCTION

Mr. Chairman, Senator Garn, and members of the Committee, I am pleased to have this opportunity to address reform of the Glass-Steagall Act.

Fortunately, a broadly based consensus on the need for some kind of reform is developing. I congratulate you, Mr. Chairman, and Senator Garn for leading the way in focusing badly needed attention on Glass-Steagall reform. Your proposal, S. 1886, provides the necessary framework for moving reform to center stage. It would permit needed competition between commercial and investment banks with administrative simplicity and directness, requiring minimal changes in the supervisory structure governing financial institutions.

Significant contributions to the building of a consensus have also come from Senators D'Amato, Cranston, Wirth, and Graham, other members of Congress and from the Administration, other financial regulators, the academic community, and the financial-services industry. In light of those endeavors, these hearings will expand the basis upon which meaningful reform must rest.

As we undertake this effort, it is important that we recognize areas of broad agreement in the three bills introduced by members of this Committee and a proposal I will outline today. We all agree that the Glass-Steagall Act is misdirected in its efforts to protect the safety and soundness of our financial institutions. We agree that reform must be coupled with insulating commercial banks from the risks of new activities, to properly restrict the availability of the safety net provided by federally insured deposits. And most importantly, we agree that reform will yield a more competitive financial services industry, benefiting all consumers of financial services. Despite any difference in approach that those of us testifying before you may have, we must not lose sight of the real issue here--banks must be allowed greater freedom to compete.

We support S. 1886, but believe that it can be enhanced in some respects. This morning, I will elaborate on some of those enhancements, outlining a model for a regulatory structure that I think should replace that created by the Glass-Steagall Act.

This proposal, which is a variation on the basic structure that you and others have proposed, is based on the principle of corporate separateness and is directed toward preserving the safety and soundness of insured depository institutions, ensuring that conflicts of interest are not resolved to the detriment of the public, and maintaining a fully competitive financial-services marketplace. This alternative also permits banks to choose from among several forms of corporate separateness and relies, with a few exceptions, on existing safeguards, rather than on extensive new layers of statutory protections. Reliance on existing safeguards reflects the fact that Congress has already fashioned laws, premised on corporate separateness, that address most of those issues of concern to us all. A review of those safeguards is contained in an appendix to this statement.

COMPETITIVE REALITIES

The need for reform rests on one basic fact: the cost of the Glass-Steagall Act--a severe reduction in competition in financial markets--is not offset by any meaningful public benefits. History tells us that the Glass-Steagall Act was designed to ensure the availability of our deposits in banks, at the cost of limiting direct competition between commercial and investment banks. However, the protection of deposits has been secured by other means--primarily federal deposit insurance. There is some irony in the fact that the law that gave us the Glass-Steagall Act--the Banking Act of 1933--also made it redundant by creating the FDIC.

Because there have been substantial economic, regulatory, and technological changes since the passage of the Glass-Steagall Act, its limitations on competition have produced significant inequities. Investment banks have been relatively free to respond to market changes by offering a host of new products, without giving up the old ones. Commercial banks have not been so fortunate. As a result, investment banks are now able to offer nearly a full line of commercial banking products, but commercial banks may not offer a full range of investment banking products. This has had a deleterious effect on the efficient provision of financial services to the American public.

Securities Firms Entering Retail Banking Markets

Securities firms are providing the equivalent of many consumer banking services. First, they offer interest-bearing checking accounts to their customers in the form of money-market mutual funds (MMFs). While MMFs are technically not deposit accounts, their shares can be redeemed by writing checks.

Second, securities firms have successfully marketed consolidated packages of financial services, combining MMFs with access to stockbrokers, securities margin accounts, and debit cards. These products include Merrill Lynch's Cash Management Account (CMA), the Shearson/American Express Financial Management Account, the Prudential Bache Command Account, and Dean Witter Reynolds' Active Asset Account. All were originally designed to attract the business of higher-income customers, with initial investment requirements of $20,000 or $25,000.

The success of those products can be seen in two developments. First, the securities firms increased the quality of the products by adding new features, such as access to stockbrokers, securities margin accounts, debit cards, pre-authorized transfers to and from bank accounts, flexible premium life insurance, and pre-authorized borrowing against the value of eligible securities. Second, the reach of the products has expanded to less affluent customers. E.F. Hutton's Asset Management Account, while offering fewer features than the other consolidated packages, has an initial investment requirement of $10,000. Merrill Lynch responded to that competition by offering a simpler version of its CMA with a $5,000 initial investment requirement.

Other competition from financial conglomerates in retail banking markets comes from their ownership of thrift institutions and nonbank banks. That competition is made all the more vigorous when those depository institutions offer credit card services. For example, United Services Automobile Association offers MasterCard through its subsidiary USAA Federal Savings Bank, Dreyfus offers MasterCard through Dreyfus Consumer Bank, Prudential offers MasterCard through Prudential Bank and Trust, John Hancock offers Visa through First Signature Bank and Trust, and Fidelity Investments offers MasterCard through Fidelity Bank and Trust.

Securities Firms Entering Wholesale Banking Markets

The Glass-Steagall Act has not prevented investment bankers from entering another traditional domain of commercial banks--the provision of credit to the corporate sector. Evidence of this competition comes from many sources. We are all familiar with the explosive growth of the commercial paper market that is dominated by investment banks. Many may not be familiar with other examples. For the years 1984 to 1987, Salomon Bros. estimates that bank loans as a percent of all new corporate debt issued will have fallen from 35 percent to 15 percent. The Loan Pricing Corporation, a bank consulting firm, recently quoted the intent of an investment banker to visit by 1993 nearly every company with sales over $25 million to convince them to give up bank loans in favor of marketable debt. Those companies currently borrow an estimated $400 billion from commercial banks.

In essence, direct access to capital markets is another version of disintermediation, which can also be seen in the growing trend of securitization. In search of more income and liquidity, major institutional lenders, including some commercial banks, have transformed loans into securities. They pool large blocks of their own loans, issue securities backed by those loans, and distribute them to a wide range of investors. Largely because of litigation contending that the Glass-Steagall Act prohibits banks from playing a role in the distribution of those securities, that field and its profits have been left largely to investment banks. It has been reported that new issues of securities backed by auto loans and credit-card receivables have reached an annual rate of $10 billion. There were virtually no such issues as recently as 1985.

Additional evidence of direct competition in wholesale lending markets can be found elsewhere. Securities firms are increasingly active in providing bridge loans to underwriting clients--the equivalent of short-term commercial bank financing. Large finance companies such as General Electric Credit Corporation are showing new aggressiveness in promoting large-denomination loans to businesses. Insurance companies and investment banks are reported to be offering long-term loans to businesses in competition with commercial banks. Companies active in this market include Connecticut General, Equitable, John Hancock, Massachusetts Mutual, Metropolitan Life, and Prudential.

Bankers Not Allowed to Meet the Competition

This explosion of new products and increased competition is a welcome development, but the ability of local banks to respond should not be limited as it is by the Glass-Steagall Act. A recent *Wall Street Journal* article (October 5, 1987) pointed out that community bankers are losing deposits to nationwide investment banks marketing products, such as money market mutual funds, and other investments in many of the smaller communities of America. Clearly, consumers benefit when those products are available. But equally clearly, the entire local community would benefit if those products were also available from local banks. One banker interviewed for the article noted that when banks lose funds, lending must decline and there is not much of a chance those denied credit could go elsewhere; investment banks, he noted, do not "finance gas stations and clothing stores."

That observation by a community banker underscores a vital point. Consumers value the convenience of being able to purchase related products at a single outlet. When banks lose customers to nonbank firms in one product line, they are likely to lose them in others. The continued presence of the bank as an effective force in its community may well depend on the ability to serve the many financial needs of individual consumers. To do that, commercial banks must be able to offer the products that are available from their competition.

Although banks have made significant efforts to offer a broader range of products and services, these have more often than not been challenged on Glass-Steagall grounds. For example, banks' efforts to offer commercial paper services to their prime corporate customers were vindicated only after years of expensive, disruptive litigation.

Similarly, several commercial banks have sought to offer to their IRA customers collective trust vehicles in a form that is permissible under existing employee benefit legislation and that builds upon the range of permissible fiduciary services that banks have, for generations, offered to their customers. Predictably, the mutual fund industry sought through court action to limit the availability of these services. Again, the commercial banking industry prevailed, but only after extended litigation.

The securities industry continues its challenges. As banks have recently sought to pool and sell interests in mortgage and consumer loans--sales of their own assets which banks have always been permitted to do--the securities industry's trade associations have been quick to take up the offensive in the courts. Similarly, bank efforts to offer new deposit instruments that link the returns to depositors to financial market indices have led to new challenges by the mutual fund industry.

The one area the securities industry has not vigorously challenged is the "plain vanilla" sale of bank loans, in whole or in part. Loan sales are confined primarily to other commercial banks and tend to be available only in relatively large denominations, and acquiring banks must receive and analyze extensive documentation associated with each sale. These features limit the usefulness of loan sales as a means of diversification, particularly in the case of attempts by community banks to package and sell loans they originate.

A well-developed secondary market in loan sales is needed, however, and would improve the safety and soundness of the banking system. It would make it easier for banks, particularly small banks, to diversify their loan portfolios. And it would add liquidity to the commercial lending market, just as mortgage-backed securities enhanced the liquidity of the housing-finance market.

SECURING THE BENEFITS OF FULL COMPETITION

Clearly, there is substantial competitive inequality between commercial banks and other providers of financial services. Just as clearly, there is one principal reason for removing those barriers, for reforming the Glass-Steagall Act: consumers will benefit. As former Comptroller of the Currency William Camp observed nearly two decades ago, "... the public interest would best be served by insuring the fullest use of the great potential of the banking system to serve consumer needs--within the limitations of bank solvency and liquidity. ... In financial, as in other markets, the presumption lies in favor of maximizing competition, and banks should not be excluded from any financial market which they may safely and prudently serve." (A New Era for Banking, remarks to the Texas Bankers Association, San Antonio, Texas, May 14, 1968.)

I have no doubt that the banking system would supply new competitive energy, if given the chance. Throughout their history, commercial banks have met many of the basic financial needs of the American public and its private and public institutions in the largest metropolitan areas and in the smallest rural communities. If banks could not offer financial services in their own name, they often supplied them as agents for those who could. Banks are the financial institution of choice for the vast majority of consumers. Numbering in excess of 14,000, banks constitute an effective and efficient system for delivering the broadest possible range of financial services. We must allow that system to work.

The approach I would suggest to achieve this objective is a very simple one. It is based on two principles.

- First, it would let banks and other providers of financial services affiliate with one another in a manner of their own choosing. However, that affiliation would be subject to the numerous safeguards governing affiliate relationships which have been passed by Congress since Glass-Steagall, strengthened in some respects.

- Second, it would rely on functional regulation. For example, securities regulators would regulate the securities companies and banking supervisors would regulate the banking companies.

The enhanced competition resulting from these changes would have far-ranging benefits to consumers of financial services. First, it would strengthen the commercial banking system by increasing income-earning opportunities, thereby reducing vulnerability to economic declines in particular geographic markets. We all benefit when the banking system is strong.

Second, we can expect improvement in the selection, availability, and quality of financial products. That expectation is based on statistical analyses and anecdotal evidence. Several studies of the insurance industry have shown that where competition has flourished, policy premiums have tended to decline and insurance options to increase. Analyses of securities underwriting syndicates have shown that permitting affiliates of commercial banks to underwrite municipal revenue bonds would likely result in significant savings to local governments. Articles and advertisements in our daily newspapers remind us that in the highly competitive retail market for computer products and in the newly competitive market for long-distance telephone service, product innovation has been as significant as has the decline in consumer prices.

By permitting needed competition between commercial and investment banks, S. 1886 takes some important first steps toward achieving those benefits. That competition would be further stimulated, and banks could take significant strides toward diversifying their portfolios, if reform legislation offered banking organizations unrestricted authority to underwrite asset-backed securities. Such underwriting poses no threat to bank safety and soundness, and it would be subject to the full range of the requirements of federal and state securities laws.

The Benefits to Community Banks

There is recognition among many who speak on their behalf that small banks need expanded powers. Representatives of community-bank trade associations and executives of many small banks are on record as supporting bank participation in underwriting commercial paper, municipal revenue bonds, mortgage-backed securities, and mutual funds. Such support is not based on the belief that all community banks would form and lead underwriting syndicates in competition with large investment banks. Rather, it is based on the belief that many community banks could participate selectively and profitably in many parts of the securities business.

For example, community banks could be members of syndicates underwriting new issues by large regional and perhaps nationwide companies, led by larger firms such as their own correspondent banks. They could form joint ventures, possibly using bankers banks, to operate and manage mutual funds. Many banks today perform limited roles in the mutual fund industry, such as distributing shares in mutual funds operated by others; the profits from those endeavors are similarly limited.

Many community banks will find it cost-effective to participate in cooperative arrangements to underwrite security interests in assets they originate, local municipal revenue bonds, and securities issued by local firms. Community banks are generally retail banks having strong relationships with community businesses and extensive knowledge of their working- and long-term capital needs. Participating in the underwriting of corporate securities would permit community banks to meet the entire spectrum of financial needs of those businesses. Because of their knowledge of the local economy, its households and business firms, community banks would be in as good a position as any other firm to market all such securities successfully.

Finally, I want to comment briefly on the fear, which has been expressed by some representatives of community banks, that permitting banks and securities firms to affiliate will further erode the competitive position of community banks in their own local markets.

It is important to keep clearly in mind that the competitive position of community banks is already being eroded today by securities firms. The small-town banker to whom I referred earlier has provided significant evidence of this effort. Permitting the affiliation of banks and securities firms, not preventing it, is the best cure for that problem.

Community banks are in as good a position as other banks to benefit from such affiliation. In their own communities they can easily take full advantage of their well-deserved reputations for providing personal service and convenience in the sale of financial services. But all the personal service and convenience in the world will not keep a customer if a bank cannot offer the products that customers demand. Banks of all sizes must be given the opportunity to offer their customers the benefits of a more competitive marketplace.

NEW REGULATIONS FOR THE FINANCIAL-SERVICES MARKETPLACE

In recent months, a number of thoughtful people have given careful consideration to the question of what regulatory framework is needed for the financial-services marketplace. Importantly, the primary emphasis has been on broad questions, such as how to design a structure that takes advantage of the numerous protections that are in existing laws, rather than focusing on the more narrow issue of which activities banks and their affiliates may safely conduct. Both S. 1886 and S. 1891 are valuable contributions, for they would make significant use of existing protections.

Using the Principle of Corporate Separation

Despite their differences, virtually all proposals for financial reform have two things in common. First, they recognize that the key to a more competitive financial services industry is the removal of barriers to the kinds of businesses with which banks may affiliate. Second, affiliation would have as its cornerstone a form of separate incorporation that would serve to insulate the bank from the affiliate.

Separate incorporation contributes to protection of the deposit insurance fund by limiting, in a verifiable manner, bank exposure to financial losses. The protections are three-fold. First, as discussed more fully below, there are laws and regulations that constrain transactions between a bank and its affiliates, including ceilings on the amount of loans to single entities and aggregate affiliations. Second, the so-called "corporate veil" can help ensure that losses flowing from an equity investment in an affiliate are limited to the size of that investment. Third, the supervision of banks by the banking agencies, and the taking of vigorous enforcement action where necessary, promote bank safety and soundness and compliance with law.

The conduct of activities in product-specific firms also minimizes, if not eliminates, any ambiguity as to which laws and regulations apply to a particular firm and which supervisor is responsible for interpreting and administering those laws and regulations.

Separate incorporation also lends itself to more accurate monitoring of how conflicts of interest are resolved because inter-firm recordkeeping requirements are usually more extensive than intra-firm requirements. By the same token, implementation of the antitrust laws is eased, because separate records ease the task of assessing market size and the relative strengths of market suppliers, two of several factors that are important in judging the extent to which anticompetitive practices are, or could be, present.

There are a number of forms of affiliation that involve separate incorporation, including affiliations through a holding company, by ownership in a venture that is owned by more than one firm, or by wholly owned subsidiaries of banks. All deserve consideration.

In fact, I see no reason to force any particular form of affiliation on the private sector. Just as banks have chosen to place some currently authorized activities in wholly owned subsidiaries or in holding company affiliates, they may similarly choose to conduct new activities in such types of subsidiaries or affiliates. They should continue to have the freedom to choose, and having chosen, their activities should be regulated and supervised in the same way and subject to exactly the same rules, regardless of where they are placed.

The proposal for structural reform that I favor would particularly enhance the ability of smaller banks to reap the benefits of product deregulation. Unlike other proposals that would require that securities activities be restricted to a subsidiary of a bank holding company, this proposal would simply require legal separation, not a particular form of affiliation. This leaves open the possibility that the bank could place the activities in a wholly owned subsidiary--a simpler and less expensive option than forming a new bank holding company.

I should point out that these subsidiaries would be distinct from "operating subsidiaries" that the OCC currently permits national banks to own, which are treated substantially as departments of the banks for federal law purposes. If Congress adopts the broad approach to Glass-Steagall reform that is contained in the bills introduced by members of this Committee, and permits banks to conduct new activities in bank-owned subsidiaries as well as in holding company affiliates, the bank subsidiaries should be treated as affiliates for federal law purposes. In discussing my proposal, I will refer to that class of subsidiaries as "insulated subsidiaries".

The insulated subsidiary option would benefit a substantial number of banks. Approximately one-third (4,700) of all commercial banks today are not affiliated with holding companies. These banks are generally smaller community banks. The freedom to choose the most appropriate form of organization in the event of product deregulation, thus, would increase the number of options available to smaller institutions.

Because of the need to make new activities readily available to smaller institutions, I find it troubling that neither S. 1886 nor S. 1891 would permit commercial banks to enter new markets through the use of a subsidiary. Our principal objective in reforming the Glass-Steagall Act is to increase competition in the financial services marketplace. We will succeed in achieving that objective only to the extent that we offer new-powers opportunities to the largest possible number of commercial banks. The lower we can keep the cost of entering new markets, the larger will be the number of new entrants. A bank-subsidiary approach keeps the cost of market entry low.

I recognize that S. 1886 offers a simplified process for securing Federal Reserve Board approval of bank holding company applications, and I applaud that effort. That simplified process, however, is not so streamlined that it would reduce significantly incorporation, legal, and other organizational fees (such as those associated with proxy statements and securities registrations) that are an ordinary part of establishing bank holding companies. In addition, it would subject those banks to the substantial costs of compliance with the requirements of an additional regulator. A low-cost market-entry option is still needed.

Activities to be Placed Outside the Bank

Determining which activities should be permitted to be conducted in a bank and which should be required to be conducted in an affiliate is an important element of Glass-Stegall reform. Clearly, it is not necessary on safety and soundness grounds alone to put all new activities in separately incorporated firms. There is no evidence that securities activities in which banks now engage have materially jeopardized the safety and soundness of any institution. Certainly, those securities activities in which a commercial bank acts solely as broker, intermediary, or consultant with little, if any, of its own funds at risk could be conducted within the bank with little risk to the deposit insurance fund. Other new activities may pose risks that are similar to those banks face in currently permitted activities--risks with which bankers and their supervisors are familiar.

In addition to risk factors, however, there are issues of simplicity, and competitive and regulatory equity, that should be considered. There is a certain appeal, for example, to having all underwriting activities regulated by the SEC.

Nonetheless, concern has been expressed that separation solely for the purpose of regulatory convenience could result in the inappropriate application of safeguards and could dilute the benefits of financial reform.

A rational method for determining oversight responsibilities over the various activities will have to be devised in conjunction with settling the other substantive issues of structural reform.

SAFEGUARDS

The regulatory framework I envision differs from that proposed by some members of this Committee in the area of safeguards. We all agree that reducing the barriers that prevent commercial banks from competing in a larger number of financial markets should not be undertaken without appropriate safeguards. In a totally unregulated marketplace, such competition could easily raise questions about three major areas of concern--bank safety and soundness, conflicts of interest, and concentrations of economic power. Fortunately, we have a host of laws and regulations that, in my view, adequately address each of those areas.

By contrast, S. 1886 seems to reflect considerable doubt about the effectiveness of those safeguards and would impose many new restrictions on bank-affiliate relationships and prohibit certain mergers. I will address those topics in turn, keeping in mind two points. First, it is important to recognize that safeguards are intended to protect insured deposits from losses that affiliates may incur; management and shareholders, however, should not be insulated from the consequences of their decisions. Second, great care must be taken when adding to current safeguards lest we reduce substantially, if not eliminate, the economic incentives for the new affiliations.

Defining Appropriate Bank/Affiliate Relationships

Extensions of credit. S. 1886 would prohibit a commercial bank from:

- extending credit to, purchasing the assets of, or issuing guarantees or letters of credit for the benefit of its securities affiliate;
- extending credit to a mutual fund advised by its securities affiliate;
- extending credit to enhance the marketability of a securities issue that is underwritten or distributed by its securities affiliate; or

- extending credit to an issuer of securities that are underwritten by the bank affiliate to pay off the principal of a loan made by the bank to the issuer.

As a general matter, I am opposed to such blanket prohibitions without evidence of abuse. Moreover, there may be situations in which the granting of the prohibited credit or purchase might be in the public interest. The bank may in fact be able to purchase securities from its affiliate on better terms than could be found elsewhere. A loan to an affiliate may be a less risky loan than one to a non-affiliated firm.

Nonetheless, there are opportunities for abuse, and Congress has already put in place a way to regulate bank/affiliate relationships--one that has stood the test of time and has recently been supplemented. I believe that this is a better way to regulate those relationships. Major safeguards dealing with bank affiliate relationships are to be found in sections 23A and 23B of the Federal Reserve Act. They limit financial transactions between a bank and its affiliates and otherwise require that major transactions be on an "arms-length" basis.

In general terms, limits on financial transactions are stipulated in section 23A. They require that commonplace transactions between a "member bank and an affiliate shall be on terms and conditions that are consistent with safe and sound banking practices." They are generally more restrictive than limitations on transactions with non-affiliated customers, such as limits on loans to an individual borrower.

Section 23B, enacted as part of the recent Competitive Equality Banking Act of 1987, applies to all insured commercial banks and generally requires that any one of several listed transactions with affiliates must be conducted on an arms-length basis. It also prohibits a bank or any of its affiliates from agreeing or indicating that the bank is responsible for the obligations of its affiliates.

Sharing of officers and directors. S. 1886 would also restrict the extent to which banks and their securities affiliates could share managerial resources. Only bank holding companies with assets of $500 million or less, or otherwise exempted by the Federal Reserve Board, could have interlocking officers and directors.

I was pleased to observe that the anti-interlock prohibitions were not all-embracing. Smaller banking organizations simply may not have available to them multiple management teams, not to mention the funds needed to support them.

The question of where to draw the line when defining "small" is difficult. Commercial banks have many fewer employees compared to other firms of the same asset size. The $500 million cutoff may not reach all banking organizations for which interlocking directorates are economically vital.

There is an alternative way to handle conflict-of-interest problems. Those who face conflicts of interest should be required to disclose such conflicts, and they should be prohibited from using inside information for personal gain. Severe penalties should be imposed for failures to make the proper disclosures or to honor the prohibitions.

Preempting State Law. S. 1886 would also deny the states the authority to allow state nonmember banks to affiliate with securities firms outside the holding company structure. Such limitations, in my opinion, would unnecessarily deprive us of the benefits and the experience accumulated under the dual banking structure. I note that the recently passed Competitive Equality Banking Act of 1987 recognized--albeit to a limited extent--the benefit of state regulation by allowing qualified savings banks to engage in activities that the state in which the savings bank is located permits it to engage.

It is important to note that affiliations with securities firms permitted by state law are conducted through bank subsidiaries and are subject to supervision and regulation by the FDIC and the SEC under a regulatory framework much like the one I am suggesting today. There is no evidence that those affiliations have jeopardized the safety and soundness of banks.

Business Combinations and Anticompetitive Practices

S. 1886 would prohibit mergers between bank holding companies (or banks) with assets of at least $30 billion and investment banking companies with assets of at least $15 billion, in an attempt to avoid undue concentrations of economic power. Any concentrations of financial resources in a manner that would shut off the availability of credit to certain sectors of the economy should be of concern to us all. However, the imposition of an arbitrary prohibition on certain mergers is not, in my judgment, an appropriate response to that concern.

The best protection against the danger that a few firms could control a market is the presence of healthy competitors. Certainly, there is vigorous competition in the markets for the products and services that commercial banks offer. That competition is provided by the 14,000 commercial banks, 3,300 thrift institutions, 15,000 federally insured credit unions, and the myriad of securities firms, insurance companies, retailers, and other companies that offer products similar to those offered by commercial banks. It seems to me that the limitation proposed in S. 1886 is not necessary to maintain competition in commercial banking markets. Most importantly for the subject of these hearings--the elimination of antiquated statutory restrictions on the ability of financial services providers to compete on equal terms--Glass-Steagall reform would be pro-competitive.

The market for investment banking services is far more concentrated than the commercial banking market. As you noted when you introduced S. 1886, Mr. Chairman, a number of the markets for investment banking services are dominated by a relatively small number of firms. As testimony before this Committee has shown for many years, traditional bank customers are turning increasingly to the securities markets. If any segment of the financial services industry merits concern regarding concentration, it is the investment banking market.

Moreover, the arbitrary size limitations that would be imposed by S. 1886 could have adverse consequences. The prohibition could unnecessarily impede the withdrawal of a large firm from a particular portion of the market through the sale of assets to the only firms not already in the investment banking business that could afford to buy them. Similarly, it could impede the orderly liquidation of a large firm that is insolvent or otherwise competitively moribund.

Arbitrary dollar limits on mergers should be abandoned in favor of vigorous enforcement of existing antitrust laws. Those laws and their enforcement will be adequate to protect against unlawful anticompetitive or collusive practices. They also provide the flexibility needed to adapt to continually changing market conditions.

Additional Safeguards

As I have indicated, I am wary of imposing unnecessary restrictions on the ability of financial services providers to compete. A safe, yet competitive, marketplace can be achieved through the use of the existing network of safeguards, coupled with four additional measures. First, financial reform legislation that provides for the conduct of certain activities through insulated subsidiaries of banks should apply the restrictions on transactions with affiliates contained in sections 23A and 23B of the Federal Reserve Act to transactions between a commercial bank and its insulated subsidiaries.

Second, bank supervisors could do much to ensure that bank capital is insulated fully from the potential risks of affiliation by deducting a bank's investment in insulated affiliates from the bank's capital when assessing the adequacy of bank capital. As long as the corporate veil remains intact, therefore, bank investments in insulated affiliates could not threaten the adequacy of bank capital. Thus, there would be no need to limit the size of such investments.

Third, in order to strengthen the corporate veil, we should consider the benefits of amending the national banking laws to prohibit national banks from being held liable for the obligations of their insulated affiliates, unless specifically assumed by a prior contractual arrangement or in egregious cases such as gross negligence or willful misconduct. Such legislation could promote bank safety and soundness as well as competitive equity by making it clear to the public that products offered by affiliates of banks are in no way protected by the safety net that supports the bank itself.

Finally, it is clear to all of us that the law must be strictly enforced if the safeguards are to work. Supervisors and regulators will have to be especially vigilant. Strong enforcement action must be taken when the occasion warrants, and we must continue to seek expanded enforcement authority as needed. A proposal that would strengthen the hand of the supervisory agencies in dealing with those who abuse financial institutions, which was developed through the joint efforts of the federal bank and thrift supervisors, was recently transmitted to the Congress. I heartily endorse those measures. Other enhancements, such as the suggestion in S. 1891 that civil money penalties be increased to as much as $10,000 per day (a sizeable increase over the current general limit of $1000 per day) are also worthy of consideration.

CONCLUSION

Organizations wishing to combine banking with other businesses should be permitted to choose from among a variety of business structures that effectively address the related concerns. A bank-subsidiary structure is but one example. It could be as safe and effective a framework for financial reform as any other. Banks could be given new sources of financial strength, without creating uncontrollable risks for the deposit insurance fund or consumers.

The means for controlling those risks are at hand and do not require extensive and radical additions or modification. Were we to impose substantial constraints on firms that offer a full range of financial services, we may inadvertently choke off the very benefits that reform of the Glass-Steagall Act can give us--a truly competitive financial-services marketplace.

As I indicated at the opening of my statement, Mr. Chairman, I support the goals that you seek to achieve in S. 1886. I hope that my suggestions today will make a contribution to the reform effort that you have started, and I look forward to working with you and the other members of the Committee in bringing to fruition the competitive opportunities for banks that have been needed for so long.

APPENDIX

EXISTING SAFEGUARDS FOR REGULATING TRANSACTIONS BETWEEN BANKS AND THEIR AFFILIATES

The existing statutory framework provides numerous safeguards which apply to transactions between a bank and its affiliates. These safeguards protect against preferential lending, tie-in requirements, conflicts of interest, unfair trade practices, and fraudulent or unsafe and unsound practices.

I. Bank Transactions with Affiliates

A. Section 23A

Section 23A of the Federal Reserve Act (12 U.S.C. § 371c) restricts transactions between member banks and their affiliates. Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. § 1828(j)) extends the coverage of Section 23A to nonmember insured banks. The objective of Section 23A is to prevent the misuse of a bank's resources that might result from the bank's financial transactions with its affiliates. This objective essentially is achieved by:

- placing quantitative limitations on "covered transactions" between a bank and its affiliate;
- establishing collateral requirements (from 100 to 130 percent) for certain transactions;
- requiring that all transactions be on terms and conditions that are consistent with safe and sound banking practices; and
- prohibiting the bank's purchase of low-quality assets from an affiliate.

Section 23A applies to various "covered transactions" between a bank and its affiliates, including --

- loans or extensions of credit to an affiliate;
- the purchase of, or investment in, securities issued by an affiliate;
- the purchase of assets (including assets subject to repurchase) from an affiliate, except for real or personal property specifically exempted by the FRB;
- the acceptance of securities issued by an affiliate as collateral security; and

- the issuance of a guarantee, acceptance or letter of credit (including an endorsement or standby letter of credit) on behalf of an affiliate.

A bank's covered transactions with any single affiliate may not exceed 10 percent of the bank's capital and surplus. Furthermore, the total amount of a bank's transactions with all of its affiliates is limited to 20 percent of the bank's capital and surplus.

B. Section 23B

Section 23B of the Federal Reserve Act (enacted as Section 102(a) of the Competitive Equality Banking Act, (Pub. L. No. 100-86)) places additional limitations on transactions between federally insured banks and their affiliates. The objective of Section 23B is to ensure "arm's length" transactions between a bank and its nonbank affiliates. Section 23B provides that a bank may engage in certain transactions with its affiliate only:

- on terms and under circumstances (including credit standards) that are substantially the same or at least as favorable to the bank and its subsidiary as those prevailing for comparable transactions with nonaffiliated companies, or

- in the absence of comparable transactions, on terms and under circumstances that in good faith would be offered to or would apply to nonaffiliated companies.

In addition to the "covered transactions" of Section 23A, Section 23B applies to the following transactions:

- the sale of securities or other assets to an affiliate including assets subject to a repurchase agreement;

- the payment of money or the furnishing of services to an affiliate under contract, lease or otherwise;

- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; and

- any transaction or series of transactions with a third party if an affiliate has a financial interest in the third party or an affiliate is a participant in the transactions.

As additional protection, Section 23B prohibits the following:

- A bank's purchase as fiduciary of any securities or other assets from an affiliate unless the purchase is permitted under the instrument creating the fiduciary relationship, by court order or appropriate law.

- A bank's purchase or other acquisition, as principal or fiduciary, during the underwriting period of any security if an affiliate is a principal underwriter (unless the purchase or acquisition is approved by a majority of bank directors who are not officers or employees of the affiliate prior to the offering of the security to the public).

- A bank's advertisement or entering into an agreement stating or suggesting that the bank will be responsible for the obligations of an affiliate.

The definition of "affiliate" under Sections 23A and 23B includes the parent holding company, other nonbank subsidiaries of the parent holding company, or companies that are commonly owned by the bank or parent holding company. A nonbank subsidiary and, for most purposes, a bank subsidiary of a bank or sister bank subsidiaries in a holding company are not covered by the restrictions of Sections 23A and 23B. The Federal Reserve Board may determine on a case-by-case basis that, because of potential detriment to the bank, these subsidiaries should be subject to the coverage of Section 23A.

Under Sections 23A and 23B, any bank transaction with a third person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.

II. Lending Limitations: Individual Borrowers

The National Bank Act (12 U.S.C. § 84) limits extensions of credit by a national bank to any single borrower to 15 percent of capital and surplus. Loans secured by readily marketable collateral are permitted up to an additional 10 percent.

II. Lending Limitations: Officers, Directors, and Shareholders

Sections 22(g) and (h) of the Federal Reserve Act (12 U.S.C. §§ 375a and 375b) restrict extensions of credit by a member bank to its executive officers, directors and principal shareholders. These restrictions also apply to officers, directors and principal shareholders of a parent bank holding company, a subsidiary of the holding company, or a company controlled by these persons. The extension of credit must be made on a nonpreferential ("arm's length") basis, and may not involve more than the normal risk of repayment or exceed the individual lending limit of 12 U.S.C. § 84. Loans are allowed only up to a limit prescribed by the regulator with prior approval required for loans of a certain amount (e.g., $25,000 or five percent of the bank's capital or surplus).

Section 106(b) of the Bank Holding Company Amendments Act of 1970 (12 U.S.C. § 1972) establishes similar requirements for extensions of credit made to officers, directors and principal shareholders of correspondent banks.

IV. Purchase of Securities From Directors

Section 22(d) of the Federal Reserve Act (12 U.S.C. § 375) prohibits a member bank from purchasing from any of its directors any securities or other property unless (i) the purchase is made in the regular course of business and on an "arm's length" basis or (ii) the purchase is approved by a majority of the bank's board of directors. Similarly, a member bank may sell securities or other property to a director only if the sale is on an arm's length basis and in the regular course of business.

V. Anti-Tying Restrictions

Section 106 of the Bank Holding Company Amendments Act of 1970 (12 U.S.C. § 1971 *et seq.*) generally prohibits a federally insured bank from providing services or extending credit on the condition that a customer obtain an additional service of the parent holding company or an affiliate (or refrain from obtaining services of a bank competitor). The Act provides injunctive relief and treble damages as remedies for the injured customer.

VI. Restrictions on Payment of Dividends

Various restrictions apply to the declaration and payment of dividends by a national bank. Dividends may not be paid out of capital (12 U.S.C. § 56). In addition, national banks and state member banks must receive regulatory approval before paying, in any calendar year, dividends exceeding the total of the year's net profits combined with the retained net profits of the preceding two years (less any required transfers to surplus) (12 U.S.C. § 60).

VII. Securities Law Requirements

A. General

The federal securities laws provide a comprehensive framework for the regulation of participants in the securities markets -- such as brokers, dealers, investment companies and investment advisers -- as well as the timely disclosure of relevant information regarding companies whose securities are offered to the public and traded in the nation's securities markets. While banks are exempt from certain of these provisions, bank holding companies and bank subsidiaries and affiliates generally are subject to federal securities law requirements and the safeguards provided by those provisions.

B. Registration and Disclosure Requirements

Section 3(a)(2) of the Securities Act of 1933 (15 U.S.C. § 77c(a)(2)) exempts banks from the registration requirements of that Act with respect to the securities they issue or guarantee. However, bank holding companies and affiliates and subsidiaries of banks are generally not exempt from those registration requirements. Several banking agencies, however, have adopted disclosure regulations governing bank sales of their securities. The Securities Exchange Act of 1934 imposes registration and disclosure requirements on banks with publicly traded securities and permits the federal bank regulatory agencies to promulgate and enforce periodic reporting and proxy regulations which are substantially similar to comparable Securities and Exchange Commission regulations. *See* 15 U.S.C. § 78l(i).

C. Anti-Fraud Provisions

All banks and their affiliates are subject to the anti-fraud provisions of the federal securities laws in connection with their securities transactions. Under these laws it is unlawful to employ any device, scheme or artifice to defraud or to make any untrue statement of a material fact, or to omit to state a material fact necessary to prevent a statement previously made from being misleading, or to engage in any other act or practice or course of business which would operate as a fraud or deceit on a person in connection with the purchase or sale of any security.

D. Conflicts of Interest Safeguards

Disclosure of material information to investors and shareholders is a basic principle underlying the securities laws. Specific disclosure obligations established under the Securities Act of 1933 and Securities Exchange Act of 1934, as well as the antifraud provisions referred to above, would require the affirmative disclosure of significant conflicts of interest in registration statements, proxy statements, or other documents filed by banks and other companies pursuant to those acts. For example, if a corporation proposed to use the proceeds of a securities offering underwritten by a bank affiliate to repay a loan to the bank, that fact would have to be disclosed in the prospectus.

In addition, numerous other provisions of the federal securities laws impose substantive regulatory requirements on many classes of securities professionals and entities, including brokers, dealers, municipal and government securities dealers, investment advisers and investment companies. Several of these provisions are designed specifically to regulate activities related to conflicts of interest. *See, e.g.*, Section 17 of the Investment Company Act of 1940, 15 U.S.C. 80a-17, governing transactions of investment companies with affiliates; Section 36 of the Investment Company Act of 1940, 15 U.S.C. § 80a-36, governing breaches of fiduciary duties of investment companies and their advisers; Section 206(3) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(3), governing prohibited transactions by investment advisers; and the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa et seq., governing generally the distribution of debt obligations pursuant to indenture.

D. Use of Credit in Securities Markets

Investor use of credit in the securities markets is subject to extensive regulatory oversight. Section 7 of the Securities Exchange Act (15 U.S.C. § 78g) authorizes the FRB to promulgate regulations governing the amount of credit which may be used to finance the purchase of any security. The FRB has adopted regulations covering extensions of credit by brokers and dealers (Regulation T) and by banks (Regulation U). It also has regulations covering extensions of credit by persons other than brokers, dealers and banks (Regulation G), the obtaining of credit by persons other than brokers or dealers (Regulation U) and arranging for others to extend credit in the securities markets (Regulations G, T and U). In addition to regulations covering extensions of credit, brokers and dealers are subject to restrictions governing their borrowing activities.

E. Financial Responsibility Provisions

Brokers and dealers are subject to a number of requirements that safeguard the financial condition of the securities firm and protect customers' funds and securities. Brokers and dealers are subject to minimum capital requirements designed to provide operational safeguards against risks associated with the securities business. See Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1. Customer funds and securities are protected from a number of risks. For example, brokerage firms must have fidelity bonding insurance to protect customers against dishonesty or misfeasance of employees (NASD Rules of Fair Practice, Section 32). In addition, customer funds and securities must be segregated and generally cannot be used by a firm to support its underwriting and dealer operations. See Exchange Act Rule 15c3-3, 17 C.F.R. § 240.15c3-3.

VIII. Federal Bank Regulatory Authority

A. Examination Authority

The National Bank Act authorizes the OCC to examine a national bank and the affairs of its affiliates as may be necessary to disclose fully the relationship between the entities and the effect of this relationship upon the bank (12 U.S.C. § 481). Pursuant to the Bank Holding Company Act, the FRB is authorized to conduct examinations of the holding company and all subsidiaries of a holding company, including the nonbanking subsidiaries (12 U.S.C. § 1844). In addition, under the Federal Reserve Act, the Board may examine all affiliates of a state member bank (12 U.S.C. § 338). Similar authority is granted to the FDIC with respect to affiliates of insured banks (12 U.S.C. § 1820(b)).

B. Enforcement Authority

- **Cease and Desist Authority**

  The federal bank regulators have cease and desist authority to address violations of law and unsafe and unsound practices, and violations of any law or regulation by banks under their supervision (12 U.S.C. § 1818). This authority allows the regulatory agencies to institute proceedings requiring any bank or bank holding company (or its directors, officers, employees, or agents) to cease and desist from unsafe and unsound practices or violations of law, and to take whatever affirmative action is necessary to correct the conditions resulting from the violations or practices. In addition, the FRB may require the termination of any holding company activity or a holding company's ownership of any nonbanking subsidiary that is judged to threaten the safety, soundness, or stability of the holding company's banks (12 U.S.C. § 1844(e)). The OCC has similar authority to terminate activities of bank operating subsidiaries.

- **Civil Money Penalty Authority**

  Various federal statutes (12 U.S.C. §§ 93, 504, 1818, 1828, 1972) give the federal bank regulatory agencies authority to assess civil money penalties against any bank, officer, employee or agent responsible for the violation. In addition, the FRB has civil money penalty authority for violations of the Bank Holding Company Act (12 U.S.C. § 1847). Violations of 23A, 23B and other statutes which restrict transactions between a bank and its affiliates are generally punishable by civil money penalties not exceeding $1,000 per day for each day during which the violation continues.

- **Removal Authority**

  Federal bank regulators also have authority to suspend or remove any director or officer of an insured bank who has engaged in unsafe and unsound banking practices, a breach of fiduciary duty or violations of law which result in loss to the bank, prejudice to depositors' interests or insider gain, and which involve personal dishonesty or a willful disregard for the bank (12 U.S.C. § 1818(e)). As a result of such a removal, the directors and officers also may be prohibited from participating in the affairs of any other insured bank without the approval of the appropriate federal regulator (12 U.S.C. § 1818(j)).

- **Securities Enforcement Powers**

  The Federal bank regulators may take administrative actions against banks that act as municipal or government securities dealers, transfer agents or clearing agencies (15 U.S.C. §§ 78o-4(c)(5), 78o-5(c)(2), 78q-1(c), (d)).

The **Chairman**. Thank you very much, Comptroller Clarke.

Chairman Ruder.

STATEMENT OF DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. **Ruder**. Chairman Proxmire and members of the committee: The Securities and Exchange Commission appreciates this opportunity to present its views concerning the possible repeal of the Glass-Steagall Act and the three bills currently under consideration by this committee: S. 1886, the proposed Financial Modernization Act; S. 1891, the proposed Financial Services Oversight Act; and S. 1905, the proposed Depository Institutions Affiliation Act.

I ask that my written statement previously submitted to the committee be included in the hearing record.

The **Chairman**. Without objection, it will be printed in full.

Mr. **Ruder**. Because S. 1905 was only introduced yesterday, it is not discussed in my written statement. I will, however, address it briefly in this opening statement.

As the Federal agency primarily responsible for regulation of the securities markets, the Commission has a fundamental interest in the protection of investors. From our perspective, what is important is that all participants in our capital markets be regulated in a manner providing protection for investors.

The Commission is unable to support repeal of Glass-Steagall unless the investor protection concerns arising from increased bank securities activities are met.

It is the Commission which is directly charged with protecting investors and we should be able to apply our regulations to all market participants. In order to assure investor protection, banks must be required to conduct both their new and their existing securities activities in separate securities affiliates subject to Commission regulation.

None of the three bills completely meets the Commission's concerns, although based upon my initial review it appears that S. 1905 would best implement this requirement.

Specifically, the Commission believes that the following activities should be conducted by banks only in securities affiliates subject to Commission regulation:

(1) Publicly advertised brokerage; that is, buying and selling securities as agent for the account of others;

(2) Brokerage services provided to advised accounts for which transaction-related compensation is received;

(3) Underwriting and dealing in corporate securities;

(4) Underwriting and dealing in municipal revenue bonds;

(5) Sponsoring, underwriting and distributing unit investment trusts; and

(6) Underwriting and distributing investment company securities.

In addition, those banks that choose to establish securities affiliates should be required to conduct their general obligation municipal securities activities in those affiliates subject to Commission oversight.

The Commission does not propose, however, that banks be required to place their Government securities or commercial paper activities in securities affiliates.

Further, if banks are permitted to underwrite and distribute investment company securities, the Investment Company Act and the Investment Advisers Act must be amended to include protections not deemed necessary when bank activities in this area were restricted.

Concerns that must be addressed include bank custody of assets of affiliated investment companies, affiliated transactions, investment company borrowing from affiliated banks, banks' activities as advisers to investment companies the independence of directors, and the use of a bank's name by an affiliated investment company.

We believe that Congress should also implement the recommendations of Vice President Bush's task group on regulation of financial services to consolidate within the Commission the securities registration and reporting requirements for all publicly owned banks and thrifts.

The views that I am expressing today are not new. The Commission has long been on record in favor of functional regulation of securities activities where that regulation conducted by the agency, the Securities and Exchange Commission, which has a special mandate and special expertise in the area of investor protection.

The Commission has been and will continue to be in contact with the banking regulators and with Members of Congress and their staffs. We would be happy to work with the committee and others with regard to the proposed legislation in order to address the Commission's investor protection concerns.

Thank you.

[The complete prepared statement of David S. Ruder follows:]

- Investigatory Powers

  The federal bank regulators have investigatory powers that extend to a bank, officers, directors or employees or agents of the bank, or its affiliates. The regulators may issue a formal order of investigation which extends to entities or persons which are not national banks or employees of national banks.

C. Reporting Requirements

National banks must file with the Office of the Comptroller of the Currency four times a year reports that disclose fully the relations between a bank and its affiliates (12 U.S.C. § 161). These reports must be verified by the oath of each affiliate's president or other designated officer. State member banks must file identical reports with the FRB three times a year (12 U.S.C. § 334). Any national or state member bank that fails to furnish the required reports is subject to a penalty of $100 for each day the violation continues.

E. Capital Adequacy

The International Lending Supervision Act authorizes federal bank regulators to establish the minimum capital required of banking institutions (12 U.S.C. § 3907). Currently, this rate is six percent of assets. Capital requirements can be changed on a case-by-case basis or for an entire class of banks through general regulations. Banking agencies may issue a directive to require a particular institution to establish a plan to increase its capital.

F. General Rulemaking Authority

Federal banking agencies have general rulemaking authority (*e.g.*, 12 U.S.C. § 93a) which may be used to promulgate new regulations or amend existing regulations as needed to provide appropriate safeguards for banks and their customers.

G. Application and Approval Requirements

The Office of the Comptroller of the Currency requires prior notice and opportunity to disapprove activities to be conducted in national bank subsidiaries. Furthermore, the OCC examines the subsidiary and may take enforcement action or order the termination of any activity that endangers the safety and soundness of the bank. The Bank Holding Company Act requires the FRB to review and approve each application to perform a nonbanking activity, other than activities specifically authorized by statute (12 U.S.C. § 1843(c)(8)).

IX. FDIC's Bona Fide Subsidiary Protections

The FDIC has promulgated regulations to govern bank transactions with affiliated securities companies (12 C.F.R. § 337.4). These provisions permit state chartered nonmember banks to engage in a full range of securities activities through a bank "bona fide" subsidiary or affiliate, provided the activities are authorized under state law. The conditions which must be met for the establishment of a "bona fide" subsidiary include:

- o adequate capitalization;
- o separation of accounting and other corporation records;
- o observance of separate formalities such as separate board of directors' meetings;
- o maintenance of separate employees who are compensated by the subsidiary;
- o having a majority of directors that are neither officers nor directors of the bank; and
- o no common officers with the bank;
- o physical separation of the operations;*
- o separate name and logo;*
- o conducting business pursuant to policies and procedures independent from the bank so as to inform customers that the bank and the subsidiary are separate organizations (including clear disclosure that the obligations of the subsidiary are not obligations of the bank) and subsidiary investments are not insured by the FDIC.*

There are no restrictions on the types of securities that can be underwritten by a subsidiary if: (1) the securities business, whether de novo or by acquisition, has been in continuous operation for five years; (2) it is in good standing with the National Association of Securities Dealers (NASD); (3) its insiders have not been subject to injunction or Securities and Exchange Commission order; and (4) each of its supervisors has five years of experience. Otherwise, underwriting is limited to investment quality debt and equity, shares of mutual funds that invest exclusively in investment quality debt and equity, and shares of money market mutual funds.

Other safeguards for the establishment and operation of a bona fide subsidiary include:

- o the requirement that the FDIC be given 60 days notice of intent to establish or acquire a securities subsidiary; and

- restrictions on the extension of credit to a securities subsidiary or affiliate (Section 23A) or to companies the securities of which are to be underwritten by the subsidiary.

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* The FDIC is considering a revision of 12 C.F.R. § 337.4 which will (i) delete the separate name and logo requirement, (ii) modify the requirement for physical separation of the bank and affiliate operations, and (iii) require more specific disclosure requirements under certain circumstances.

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
CONCERNING
REPEAL OF THE GLASS-STEAGALL ACT, S. 1886, AND S. 1891

December 3, 1987

EXECUTIVE SUMMARY

Regulation of Bank Broker-Dealer Activities. The Commission is unable to support repeal of the Glass-Steagall Act unless the securities investor protection concerns arising from increased bank securities activities are simultaneously addressed. Many of the Commission's concerns result from the dramatic expansion of banks into securities activities without Commission regulation, and not specifically from the current proposals to repeal Glass-Steagall. Neither of the bills currently under consideration by this Committee -- S. 1886 and S. 1891 -- meets these concerns. In order to ensure investor protection, banks must be required to conduct both their new and existing securities activities in separate securities affiliates, subject to Commission regulation.

Specifically, the Commission believes that the following activities should be permitted only in securities affiliates, subject to Commission regulation.

(1) publicly-advertised brokerage (buying and selling securities as agent for the accounts of others);

(2) brokerage services provided to advised accounts for which transaction-related compensation is received;

(3) corporate securities dealing or underwriting, including private placements of securities;

(4) municipal revenue bond underwriting and dealing;

(5) sponsoring, underwriting, and distributing unit investment trusts; and

(6) underwriting and distributing investment company securities.

In addition, those banks that choose to establish securities affiliates should be required to conduct their general obligation municipal securities activities in those affiliates subject to direct Commission oversight. The Commission does not propose, however, that banks be required to place their government securities or commercial paper activities in securities affiliates.

S. 1886 would only partially provide for Commission regulation of bank securities activities. Although the bill would require that most of the new securities powers given banks be conducted in separate affiliates subject to Commission regulation, banks could continue to conduct their existing securities activities outside of the federal securities laws. Accordingly, the Commission recommends that S. 1886, or any other proposal to amend Glass-Steagall, include the substance of an earlier Commission legislative proposal, which was introduced by Senator D'Amato as S. 1175.

Investment Company Protections. If banks are permitted to underwrite and distribute investment company securities, the Investment Company Act and the Investment Advisers Act must be amended. Because the two Acts were drafted in the context of the separation between banking and securities mandated by Glass-Steagall, they do not adequately address the investor protection concerns that will arise if banks are permitted to engage generally in the investment company business. Concerns that must be addressed include bank custody of assets of affiliated investment companies, affiliated transactions, investment company borrowing from affiliated banks, bank advising of investment companies, the independence of directors, and the use of a bank's name by an affiliated investment company.

Bank and Thrift Issuer Activities. Legislation repealing Glass-Steagall should also implement the recommendations of Vice President Bush's Task Group on Regulation of Financial Services to consolidate within the Commission the securities registration and reporting requirements for all publicly-owned banks and thrifts. The recommendations would aid in establishing uniform accounting standards and disclosure requirements and enable investors to receive the same disclosure protections with respect to securities issued by publicly-owned banks and thrifts as they now receive for other publicly-owned companies.

Protections Against Conflicts of Interest. If Glass-Steagall is repealed, conflicts of interest and related investor protection concerns will arise that will not be fully addressed by a separate affiliate requirement. Congress should consider measures to address concerns regarding misuse of confidential information, bank placement of underwritings in controlled accounts, bank extension of credit to purchasers of securities, and investor confusion between banks and their affiliates.

Bank Holding Company Regulation. The Commission generally supports the approach in S. 1886 and S. 1891 of permitting new securities powers only through a securities affiliate of a bank holding company, although it believes that it may be appropriate to allow small banks that engage in limited securities activities to do so through bank subsidiaries, subject to Commission regulation. The Commission also recommends a change to the limited exemption from Bank Holding Company Act regulation in S. 1886 for holding companies primarily engaged in securities activities. This change would key the exemption to the holding company having few resources devoted to banking.

The Commission would be happy to work with the Committee to amend the proposed legislation to address the Commission's investor protection concerns.

I. INTRODUCTION

The Securities and Exchange Commission appreciates this opportunity to present its views concerning the repeal of the Glass-Steagall Act, and to comment on S. 1886, the proposed Financial Modernization Act of 1987, and S. 1891, the proposed Financial Services Oversight Act. The Commission is unable to support repeal of Glass-Steagall unless investor protection concerns arising from increased bank securities activities are simultaneously addressed. Many of the Commission's concerns arise from the dramatic expansion of banks into securities activities without Commission regulation and not specifically from the current proposals being considered by this committee to repeal Glass-Steagall.

The policies underlying the federal securities laws have different objectives than those underlying banking regulation. While banking regulation seeks to ensure the safety and soundness of the banking system and to protect depositors, securities regulation seeks to protect investors and maintain fair and orderly markets. These policies are accomplished by a regulatory scheme that includes:

(1) full and fair disclosure in the purchase and sale of securities;

(2) registration and regulation of all broker-dealer activity; and

(3) protection against conflicts of interest and dishonest practices in the sale and management of professionally managed pools of capital.

Neither S. 1886 nor S. 1891, as currently drafted, adequately addresses securities law policies. In order to ensure investor protection, legislation repealing Glass-Steagall must require banks to conduct both their new and their existing securities activities in separate securities affiliates subject to Commission regulation and amend the Investment Company Act and Investment Advisers Act to address specific investor protection concerns caused by bank entry into the investment company business. In addition, to achieve full functional regulation, securities registration and reporting requirements should be consolidated within the Commission for all publicly-owned banks and thrifts. Congress also should consider additional safeguards regarding other conflicts of interest and related investor protection concerns created by Glass-Steagall repeal.

The Commission would be pleased to work with the Committee to implement the changes recommended in this statement in any legislation that would repeal Glass-Steagall or in legislation that would adopt the concepts of S. 1175.

II. S. 1886 AND S. 1891

The proposed Financial Modernization Act, S. 1886, would repeal Sections 20 and 32 of Glass-Steagall. Section 20 prohibits any bank that is a member of the Federal Reserve System from affiliating with an entity "principally engaged" in the issue, flotation, underwriting, public sale, or distribution of securities; Section 32 prohibits an officer, director, or employee of a member bank from serving as an officer, director, or employee of a company "primarily engaged" in underwriting or other activities similar to those listed in Section 20.

S. 1886 would permit banks to engage in a wide range of securities activities (including securities underwriting and dealing) through separately capitalized affiliates operating within a holding company structure. Holding companies predominantly engaged in securities activities would be exempted from the Federal Reserve Board's examination, reporting, and capital requirements.

S. 1886 contains certain regulatory safeguards. These include a general prohibition against loans from banks to securities affiliates, mandatory disclosure by securities affiliates to customers that the securities sold by the affiliate are not backed by banks or subject to federal deposit insurance, and a prohibition on banks loans to customers for the purchase of securities underwritten by securities affiliates during underwritings and for 30 days thereafter. However, under the bill, a bank could continue to conduct within the bank all securities activities it lawfully engaged in before November 18, 1987. These include publicly-advertised brokerage services, brokerage for advised accounts, private placements of certain securities, mutual fund and unit investment trust distribution, and underwriting and dealing in general obligation municipal securities. The bill would also permit a bank to underwrite within the bank municipal revenue bonds and certain unit investment trusts. All these securities activities to be conducted within the bank would remain outside the Commission's jurisdiction.

S. 1891, the proposed Financial Services Oversight Act, would restructure the current financial regulatory system by creating three types of holding companies that could engage in specified financial securities activities. First, a bank (or thrift) holding company could own and control one or more banks or thrifts, and could engage in a broad range of financial services. Such a bank holding company could not, however, be owned or controlled by a nonfinancial commercial concern, nor could it engage in nonfinancial activities. Second, a "financial holding company" could offer noninsured transaction accounts and have access to the national electronic payments system. It could not, however, own a bank or a thrift, and, if it purchased an insured bank or thrift, would automatically become a bank or thrift holding company. Such a company could not be owned by a commercial firm.

Finally, a "commercial holding company" would be permitted to engage in any commercial enterprise and could also engage in nonbank financial activities, but would not be allowed to own banks or thrifts.

S. 1891 would also establish a Financial Services Oversight Commission that would be composed, in part, of the heads of the federal financial regulatory agencies. The new commission would be charged with promulgating rules and regulations for the three different types of holding companies and with taking appropriate action to enforce compliance of its regulations, either directly or through referrals to other regulators. The bill would amend the Bank Holding Company Act, the Federal Reserve Act, the Glass-Steagall Act, and other laws to permit activities that would be lawful for each of the three types of holding companies established by S. 1891. Finally, the bill would create a National Electronics Payments Corporation that would establish, operate, and maintain a national electronic payments system.

III. INVESTOR PROTECTION CONCERNS RAISED BY THE REPEAL OF THE GLASS-STEAGALL ACT

Both S. 1886 and S. 1891 are primarily designed to permit banks to expand their securities activities while minimizing risks to the safety and soundness of our Nation's banks and banking system. These proposals do not adequately address policies relating to the protection of investors and the maintenance of fair and orderly securities markets that arise with bank entry into the securities markets. These policies have long been declared essential to the welfare of the Nation and must be addressed in the current legislation. First, these proposals for repeal do not require all bank securities activities to be conducted within the regulatory scheme for broker-dealers which Congress designed to ensure the protection of securities investors. Second, these proposals do not address the problems raised by bank entry into investment company activities.

A. Regulation of Bank Broker-Dealer Activities

The federal securities laws provide a comprehensive scheme of regulation for our Nation's securities markets. These laws have as their primary goals the protection of investors and the maintenance of fair and orderly markets. A major component of the regulatory structure established by Congress is the regulation of brokers and dealers -- that is, those entities engaged in the business of effecting transactions in securities, either for their own account or for the account of others.

Banks have been exempt from broker-dealer regulation since the enactment of the Securities Exchange Act in 1934. In recent years, banks have expanded dramatically their securities activities, but have continued to operate outside of the regulatory scheme for registered broker-dealers. If Glass-Steagall is to be repealed, banks must be required to conduct their expanded securities activities and their current securities activities in affiliates subject to Commission regulation, with certain limited exceptions. Among the specific activities that must be placed in such affiliates are:

(1) publicly-advertised brokerage activities;

(2) brokerage services provided to advised accounts for which transaction-related compensation is received;

(3) corporate securities dealing or underwriting, including private placements;

(4) municipal revenue bond underwriting and dealing;

(5) underwriting of unit investment trusts; and

(6) distribution of investment company shares.

1. The Regulatory Scheme for Broker-Dealers

The Exchange Act and the rules promulgated thereunder impose on broker-dealers registered with the Commission extensive net capital, books and records, and customer protection rules, specifically designed to protect securities investors. Additional rules, which are subject to Commission approval, are imposed by the self-regulatory organizations, to which all registered broker-dealers must belong, such as the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange. Compliance with these rules and with the federal securities laws is monitored by both the Commission and the self-regulatory organizations. The self-regulatory organizations in turn are subject to regulation by the Commission.

To ensure that broker-dealers can meet their financial responsibilities to their customers and to other market participants, all registered broker-dealers must comply with the Commission's net capital rule, which is designed to ensure the solvency of securities firms. The net capital rule requires that broker-dealers maintain at all times a minimum capital level. The rule requires that, in computing their capital, broker-dealers value their assets at current market prices, rather than at historical values as banks are permitted to do. The rule also reduces capital allowances for large concentrations in particular securities. When a broker-dealer's net capital falls below required levels, it must immediately notify the Commission and cease operations unless additional capital is obtained.

To ensure that securities professionals meet their fiduciary responsibilities toward investors, the Commission and the self-regulatory organizations have developed a comprehensive scheme for qualifying, examining, and supervising persons employed in the industry. A registered broker-dealer's sales and supervisory personnel must meet the competency standards established by the Commission and the self-regulatory organizations. For example, registered representatives of NASD firms who are engaged in sales and trading activities are tested for product and market knowledge, and registered principals responsible for management and supervision are examined for knowledge of the securities laws. These examinations protect investors by assuring that registered representatives are knowledgeable about the products they recommend and sell to investors and that registered principals understand the laws and regulations with which they must ensure compliance. In addition, the self-regulatory organizations review the backgrounds of those seeking employment in the industry to determine whether there are legal impediments to registering them as securities professionals. Moreover, under the Commission's statutory scheme, federal securities law violators and others may be barred or restricted from participation in the securities industry.

These competency requirements are augmented by the obligations imposed on broker-dealers to supervise their employees to prevent securities law violations. The rules of the self-regulatory organizations provide for sanctions in the event of deficiencies in supervision, and the Commission has significant enforcement remedies available if brokerage firms fail to supervise adequately their employees to prevent violations of the securities laws.

As a further measure to promote compliance with the securities laws, the Commission imposes on registered broker-dealers an extensive examination and recordkeeping program. The Commission and the self-regulatory organizations inspect registered broker-dealers to ensure compliance with, among other things, financial responsibility requirements and maintenance of books and records. They also inspect to detect trading and sales practice abuses such as market manipulation, excessive or unauthorized trading, and unsuitable recommendations to customers. Additionally, Congress has provided the Commission with specific authority to review disciplinary sanctions against self-regulatory organization members to ensure that the self-regulatory organizations perform their statutory oversight responsibilities. This authority, and the Commission's market regulation inspection and examination program, which audits surveillance and compliance programs of self-regulatory organizations, provide additional safeguards for investors.

The NASD's examination program is illustrative of the comprehensive scheme for inspection of registered broker-dealers to ensure investor protection. First, NASD inspections are conducted by a team of specially trained examiners who undergo extensive training to detect problems peculiar to the securities industry. Second, NASD inspections focus on, among other things, operational practices and seek to uncover abusive sales practices. Finally, NASD members must make their books and records available to the Commission and the NASD on demand. Violations uncovered by NASD inspections can lead to significant sanctions, including suspension or expulsion from the industry and heavy fines.

Broker-dealers must also comply with the detailed guidelines set by their self-regulatory organizations concerning the content and review of advertisements. These include requirements that all communications with the public be based on principles of fair dealing and good faith and that such communications disclose all material information in a non-misleading manner. In addition to these general requirements, the NASD requires that all advertising materials be approved by a registered principal prior to their use; that specific information be disclosed, including the name of the member, the preparer of the material, and the date on which the material was first published, circulated, or distributed, when materials are not current; and that the advertisements exclude references that might imply endorsement or approval of the securities being offered by the NASD or by any other regulatory body.

Under the Securities Investor Protection Act, customers are protected from loss of cash on securities held by broker-dealers registered with the Commission. Customers' accounts are insured up to $500,000 (including $100,000 in cash) by the Securities Investor Protection Corporation ("SIPC") To fund its insurance program SIPC tion imposes on registered broker-dealers assessments based on their level of business activity. SIPC also may borrow up to $1 billion from the United States Treasury, through the Commission.

2. Current Status of Banks Under the Exchange Act

As currently written, the federal securities laws generally do not regulate banks when they engage in securities activities. Banks are expressly excluded from the definitions of "broker" and "dealer" under Sections 3(a)(4) and 3(a)(5) of the Exchange Act. Under these exclusions, banks may engage in agency transactions on behalf of public customers and in principal securities transactions on their own behalf without registering with the Commission as brokers or dealers.

In 1934, when Congress excluded banks from the definitions of "broker" and "dealer" in the newly-enacted Exchange Act, it presumed that banks could not engage in retail brokerage business under the banking laws as interpreted by the banking regulators, a presumption that essentially remained unchallenged for forty years. In 1934, the only brokerage activities in which banks could engage were "accommodation" trades, that is, trades for existing bank customers on a not-for-profit basis. The Act's legislative history demonstrates that this restriction on bank entry into the brokerage business was one of the principal factors in Congress' decision to exclude banks from the Exchange Act's definitions of broker and dealer. 1/ In view of the limited nature of bank securities activities, Congress believed that the full panoply of the federal securities laws was unnecessary.

In the 1980s, however, banks have emerged as a significant component of the retail brokerage market through their discount brokerage operations. Moreover, recent decisions of bank regulators have allowed banks to combine brokerage with investment advisory services, increasing the potential for improper sales practices and similar abuses. In addition, banks have become major participants in the distribution of mutual funds and unit investment trusts. Furthermore, banks have begun to sell to their customers securities backed by loans originated by the bank.

All of these activities raise substantial investor protection concerns. The regulation of bank securities activities under federal banking law is not an adequate substitute for Commission regulation. The primary purposes of federal banking law are the protection of depositors and the preservation of the safety and soundness of the banking system. Banking law is not directed at the protection of investors and the maintenance of fair and orderly securities markets. Banking law does not provide for the testing and supervision of employees that sell securities to the public, nor does it provide for pervasive examination of bank brokerage operations by personnel trained to detect problems peculiar to the securities markets. Banks are not required to be members of securities self-regulatory organizations and may advertise their brokerage operations outside the guidelines of the self-regulatory organizations. The Federal Deposit Insurance Corporation does not protect the securities of customers held at banks.

The Commission believes that bank securities activities must be brought within the structure of the laws and rules designed by Congress, the Commission, and the self-regulatory organizations to ensure complete and effective regulation of the securities markets, investor protection, and the maintenance of fair and orderly markets.

1/ See Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8920 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 86 (Feb. 16, 1934)(statement of Thomas G. Corcoran, an administration spokesman and a principal drafter of the Exchange Act).

3. Bank Broker-Dealer Activities and S. 1886

a. Existing Securities Activities

S. 1886 would provide only partially for Commission regulation of bank securities activities. Under Section 102 of the bill, most of the new powers extended to banks would be required to be conducted in separate affiliates, thus providing for appropriate regulation of those activities to ensure investor protection. This requirement would also increase the insulation of insured bank deposits from the risks of the securities markets since securities affiliates would be subject to the Commission's net capital rule.

However, S. 1886 would not address the regulatory gaps created by existing bank broker-dealer activities. Significantly, banks' existing securities activities, which include publicly-advertised brokerage, brokerage for advised accounts, private placements of certain securities, mutual fund and unit investment trust distribution, and underwriting and dealing in general obligation municipal securities, could remain in the bank and would not be subject to Commission regulation. It is the Commission's position that Glass-Steagall should not be repealed unless the full range of bank securities activities are brought under the regulatory umbrella of the federal securities laws. Thus, S. 1886 should be amended to provide that current bank securities activities are regulated under the federal securities laws. 2/

b. Municipal Securities Activities

Moreover, if Glass-Steagall is repealed, banks that choose to engage in expanded powers should be required to transfer their current municipal securities activities to the separate securities affiliates that they will be required to establish in order to engage in the expanded powers. S. 1886 instead would allow banks to continue to underwrite and deal in general obligation municipal securities without forming an affiliate and also to begin underwriting of municipal revenue bonds within the bank. 3/

Under the current scheme as provided in the Securities Acts Amendments of 1975, the Commission and the bank regulators share examination and enforcement authority over municipal securities dealers, including banks. This shared responsibility resulted

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2/ As discussed below, exceptions would be made for banks' government securities activities, and, under certain circumstances, for their general obligation municipal securities activities.

3/ Section 108 (amending Section 16 of the Glass-Steagall Act).

from Congress' decision not to require banks to set up separate affiliates to carry out municipal securities activities. Congress thought it would be burdensome for banks to have the Commission perform examinations of a bank's municipal securities activities that generally constitute only a small portion of a commercial bank's business.

However, if banks are allowed to expand their securities activities, the potential for inefficient and uneven regulation that results from shared responsibility will increase. This is of particular concern because of the somewhat greater "issuer" risk involved in municipal revenue bonds than in general obligation bonds. Accordingly, S. 1886 should be amended to require that bank municipal revenue bond activities be conducted in separate affiliates. Moreover, banks that do establish securities affiliates also should be required to conduct their general obligation municipal securities activities in those separate affiliates subject to direct Commission oversight, since this would increase investor protection at little or no additional cost to those banks that form affiliates. [4]

c. Mutual Fund and Unit Investment Trust Activities

S. 1886 also would permit a bank to distribute mutual fund shares and to underwrite certain unit investment trusts [5] directly,

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[4] However, the Commission does not propose that banks that restrict their securities activities solely to the underwriting of general obligation municipal securities and government securities be required to place their underwriting of general obligation municipal securities in separate affiliates. Nor does the Commission recommend that banks be required to place their government securities activities in separate affiliates, since it believes that the scheme of shared responsibility established by the Government Securities Act of 1986 is adequate to address the more limited investor protection concerns that arise in that market. Finally, the Commission does not recommend that banks be required to underwrite and deal in commercial paper through separate affiliates, since entities that deal exclusively in commercial paper, bankers' acceptances, and commercial bills are not required to register with the Commission as broker-dealers.

[5] A unit investment trust is an unmanaged investment company that holds a portfolio of securities assembled by the trust's sponsor and issues redeemable interests in the trust to investors.

[6] Section 108 (amending Section 16 of the Glass-Steagall Act).

rather than through a regulated securities affiliate. 6/ This provision should be changed. Banks distributing mutual funds and unit investment trusts to their customers should be required to conduct these activities in separate affiliates subject to broker-dealer regulation by the Commission and the self-regulatory organizations. Without this regulation, unregulated entities using untrained personnel may sell investment company securities without Commission and self-regulatory organization oversight of their sales practices, advertising, and sales commissions, creating serious investor protection concerns.

4. S. 1175

To address the concerns posed by current unregulated bank securities activities, the Commission previously proposed that the Exchange Act's definitions of "broker" and "dealer" be amended to include banks that conduct certain securities activities. The substance of the Commission's proposal should be included in any legislation allowing banks increased securities powers. 7/ The proposed legislation was introduced in the Senate on May 8, 1987, by Senator D'Amato as S. 1175. 8/ S. 1175 would include within the definitions of "broker" and "dealer" those banks that (1) publicly solicit brokerage business, (2) receive transaction-related compensation for brokerage services provided to advised accounts, 9/ or (3) deal in or underwrite securities.

S. 1175 also would amend Section 15(a) of the Exchange Act to require that banks establish separate entities, registered with the Commission, to engage in certain securities activities. This would separate the Commission's regulation of a bank's securities activities from the operation and regulation of the bank's banking activities. Without this requirement, a bank could, theoretically, register with the Commission as a broker-dealer, leading to regulatory conflicts. For instance, a bank could find itself subject to both the Commission's net capital rule and the bank regulators' capital requirements. In addition, in the event of a liquidation of a bank, both the Securities Investor Protection Corporation and the Federal Deposit Insurance Corporation could find themselves charged with liquidating the same entity.

7/ The Commission urges that this legislation be enacted even if the Glass-Steagall Act is not repealed.

8/ S. 1175 and the Commission's statement in support of that legislation are attached. The bill was introduced in the House as H.R. 2557, the "Bank Broker-Dealer Act of 1987."

9/ "Brokerage services provided to advised accounts" include investment advice provided in conjunction with execution services.

The Commission recognizes that there may be some bank securities activities that do not require extensive Commission oversight. Accordingly, S. 1175 would permit the Commission to exempt certain banks, by rule, regulation, or order, from the definitions of "broker" and "dealer," either unconditionally or subject to certain terms and conditions. The Commission would also retain its authority to exempt banks from the registration requirements of Section 15(a) of the Exchange Act. These provisions would ensure that activities that fall within the terms of the statutory provisions, but are not necessarily appropriate for Commission regulation, may be exempted. 10/

B. Concerns Arising from Bank Investment Company Activities

If banks are permitted to engage in a broad range of securities activities, the Investment Company Act and the Investment Advisers Act must be amended. These two Acts address specifically many of the conflicts that arise when brokerage firms or their affiliates conduct mutual fund and unit investment trust activities. However, because the two Acts were drafted in the context of the separation between banking and securities mandated by the Glass-Steagall Act, they do not adequately address the conflicts and other investor protection concerns that will arise if banks are permitted to engage generally in the investment company business.

1. Custody of Investment Company Assets

Sections 17 and 26 of the Investment Company Act should be amended to clarify and strengthen the Commission's authority to promulgate regulations governing how banks may serve as custodians of affiliated management investment companies and as trustees of affiliated unit investment trusts. The Investment Company Act currently requires every management investment company to maintain its securities and similar investments in the custody of a bank, or, subject to Commission rules, in a member of a national securities exchange or the investment company itself. To minimize the opportunities for misuse of investment company assets, the Commission has used its rulemaking authority to impose stringent safeguards on self-custodianship by management investment companies and on broker-dealer custodianship.

10/ For example, banks that conducted a de minimus amount of brokerage transactions might be exempted under this provision.

Similarly, the Investment Company Act requires the trustee of a unit investment trust to be a bank meeting certain criteria. If a bank's securities affiliate were to act as the sponsor or underwriter of a unit investment trust, the Investment Company Act would currently permit the bank to act as trustee with custody of trust assets. Because of the nature of unit investment trusts, securityholders must rely on the trustee to ensure that assets are safeguarded, disbursements are proper, and the trust otherwise operates in accordance with the trust indenture. Given the courses of dealing that develop between a sponsor and a trustee bank under the unit investment trust format, the independence of the bank trustee may be compromised if it is affiliated with the sponsor. For example, a sponsor could improperly influence the trustee's performance of its duties with respect to disbursements to the sponsor for services performed for the trust or in valuing units being redeemed by the sponsor. 11/

The Commission should be given explicit rulemaking authority to prescribe appropriate requirements for investor protection where a bank affiliated with a management investment company seeks to act as its custodian or where a bank affiliated with a unit investment trust seeks to serve as its trustee.

2. Affiliated Transactions

The current regulatory framework does not address the potential conflicts of interest involving bank-affiliated investment companies that will arise from the interrelationships that exist between banks and their commercial borrowers. Accordingly, the Investment Company Act should be amended to regulate these conflicts.

The most basic of these conflicts would arise when the affiliated investment company invests in a corporation in order to further the bank's interests as a creditor of the corporation. In most circumstances, the bank's corporate borrower and the investment company would not be "affiliated persons" for purposes of the Investment Company Act, and thus, not subject to the Act's prohibitions against transactions between an investment company and its affiliated persons. Therefore, a bank-affiliated investment company

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11/ To prevent the trust from shrinking through redemptions by investors, the trust sponsor generally will maintain a secondary market in trust units, but from time to time will present to the trustee for redemption trust units it has accumulated in its secondary market activities.

could be used by the bank as a source of readily available capital to bail out a financially troubled creditor. For example, a bank-affiliated investment company could purchase securities from a financially troubled corporation, and the proceeds of that purchase could be used by the corporation to repay its indebtedness to the bank. The bank would benefit by liquidating bad or illiquid loans at a potentially inflated price, but the investment company would be left with risky assets.

Accordingly, the Act must be amended to prohibit generally a borrower and any of its affiliates having a substantial borrowing relationship with a bank from knowingly selling securities or other property to, purchasing securities or other property from, or borrowing from an investment company affiliated with the bank. 12/ To eliminate potential disadvantages to the shareholders of the investment company resulting from this prohibition, the Commission should be given the authority to exempt proposed transactions from this new provision.

3. Borrowing from an Affiliated Bank

To avoid the potential abuse of overreaching by a bank affiliate in a loan transaction with an investment company, Section 18 of the Investment Company Act should be amended to prohibit a bank-affiliated investment company from borrowing from its affiliated bank or banks, except in accordance with Commission rules.

Currently, the Investment Company Act prohibits an open-end investment company from issuing any security senior to its common shares, but permits the company to borrow from any bank, provided that immediately after the borrowing there is an asset coverage of at least 300% for all borrowings. Therefore, absent new legislation, a bank-affiliated investment company could borrow money from its bank affiliate without restrictions.

12/ Under Section 10(f) of the Investment Company Act, registered investment companies are prohibited, except under limited circumstances, from purchasing securities sold or underwritten by a syndicate where affiliated persons are involved in the syndicate, even though the purchase is not made from an affiliated person. However, unit investment trusts are generally excepted from the Section 10(f) prohibitions. The Commission believes that further study is necessary to determine whether the existence of bank lending and other relationships presents increased concerns that warrant re-examination of this exception.

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4. Advising Investment Companies

Effective oversight by the Commission of the activities of registered investment companies requires that all advisers to investment companies -- including banks -- be subject to Advisers Act regulation. Accordingly, Section 202(a)(11) of the Advisers Act should be amended to remove the current exclusion from the definition of "investment adviser" for those banks that serve as advisers to registered investment companies. The exclusion for banks with no investment company clients may be retained.

Banks currently may serve as advisers to registered investment companies. However, because banks and bank holding companies are excluded from the Advisers Act definition of investment adviser, banks that advise investment companies are not subject to Advisers Act regulation.

Removing this exclusion would be consistent with Congress' removal in 1970 of certain Advisers Act exceptions that had previously been available to advisers to registered investment companies. These changes extended the bookkeeping and inspection requirements to all investment company advisers other than banks. In addition, subjecting banks' management of investment companies to Advisers Act regulation would close substantive regulatory gaps by, for example, subjecting them to the Advisers Act's restrictions on performance fees and agency cross transactions.

5. Independent Directors

If a bank and the investment company sponsored by the bank are allowed to share directors, there is a danger that the directors will engage in self-dealing. Accordingly, the Commission recommends amending Section 10(c) of the Investment Company Act. This section currently provides that no registered investment company may have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank. This section should be amended to include, within the class of covered persons, directors, officers and employees of a bank holding company and any company affiliated with it. This amendment would eliminate the potential to circumvent the legislative intent of this subsection by a bank operating under a multiple bank holding company structure.

Also, the Commission believes that bank sponsorship of investment companies may require that additional persons, because of their business relationships with a bank, to be deemed "interested persons," disqualified from serving as independent directors of any investment company affiliated with the bank. Investment Company

Act Section 10(a) currently provides that at least 40 percent of an investment company's board of directors must be composed of individuals who are not "interested persons." Accordingly, it may be appropriate to amend the definition of "interested person" in Section 2(a)(19) of the Investment Company Act to include within the term certain persons with significant relationships to a bank affiliated with an investment company.

6. Use of the Bank's Name

In order to prevent public confusion between a bank, the deposits of which are federally insured, and an investment company affiliated with the bank, the assets of which are subject to investment risk, Section 35(d) of the Investment Company Act should be amended to make it unlawful for a bank-affiliated investment company to use the bank's name as part of the name or title of the investment company.

IV. REGULATION OF BANK AND THRIFT DISCLOSURE

Legislation repealing Glass-Steagall should also implement the recommendations of Vice President Bush's Task Group on Regulation of Financial Services regarding bank and thrift issuer activities. The Task Group was formed in 1982 to address problems arising from the blurring of the lines between the banking and securities industries and the overlapping, excessive, and conflicting regulation of agencies with jurisdiction over the financial services industries. The members of the Task Group consisted of the heads of the financial regulatory agencies, including former Commission Chairman John Shad. Two important Task Group recommendations concern securities issued by banks and thrifts. The Task Group unanimously recommended that: 13/

- Public offerings of securities (but not deposit instruments) by banks and thrifts should be made subject to the registration requirements of the Securities Act by amending Sections 3(a)(2) and 3(a)(5); and

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13/ The Federal Home Loan Bank Board subsequently withdrew its support for these Task Group recommendations. *See* House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 100th Cong., 1st Sess., *Consolidating the Administration and Enforcement of the Federal Securities Laws within the Securities and Exchange Commission* 18-19 (Comm. Print 1987).

- Administration and enforcement of disclosure requirements under the Securities Exchange Act should be transferred exclusively to the Commission by repealing Section 12(i).

The Commission continues to support these recommendations. 14/ These recommendations would consolidate within the Commission the financial disclosure requirements for all publicly-owned companies, as well as for public offerings of securities. They would ensure that investors will receive the same disclosure protections with respect to securities issued by publicly-owned banks and thrifts as they now receive for other publicly-owned companies.

Under the current system, the bank and thrift regulatory agencies have jurisdiction over disclosure requirements for securities issued to public investors by about 400 banks and 300 thrifts and the Commission has jurisdiction over such requirements for securities issued by about 1,000 bank and thrift holding companies. This means that there may be differences in disclosures relating to banks and thrifts, depending on whether they are owned by holding companies. There also may be differences in whether audits are conducted by independent public accountants.

Uniform accounting standards and disclosure requirements facilitate comparative analyses of investment alternatives among individual institutions, as well as between industry groups such as banks, thrifts, finance companies, and securities firms. Such comparative analyses are fundamental to sound investment decisions and efficient securities markets.

14/ Earlier this year, in its report on the financial guarantee market, the Commission reaffirmed its support for these Task Group recommendations and also endorsed the Task Group's recommendation for Commission exemptive authority under the Securities Act of 1933. The Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee recently made recommendations substantially similar to the Task Group recommendations regarding the treatment of bank and thrift securities. *See* House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 100th Cong., 1st Sess., *Consolidating the Administration and Enforcement of the Federal Securities Laws Within the Securities and Exchange Commission* 1-4 (Comm. Print 1987).

Enactment of the Task Group recommendations would result in more uniform regulation and enforcement of financial institution disclosure to investors. It would eliminate delays by the various agencies in conforming their regulations governing depository institutions filings with those adopted by the Commission. It would also provide for equivalent access to information concerning banks and thrifts and other publicly-owned companies.

V. CONFLICTS OF INTEREST AND RELATED CONCERNS ARISING FROM BANK SECURITIES ACTIVITIES

In enacting Glass-Steagall, Congress sought to address the abuses in the bank securities affiliate system identified in the extensive Senate hearings into stock exchange practices of the 1920's, including those involving serious conflicts of interest. The legislative history of the Act reflects Congress' belief that bank affiliates had engaged in a variety of serious abuses, including the issuance of unsound and speculative securities, the making of false and misleading statements in new issue prospectuses, and the use of affiliates to conceal bad loans. Congress was also concerned about apparent conflicts of interest arising from banks lending to affiliates to finance underwritings, to customers to purchase the securities underwritten by the affiliates, and to the corporations that used the affiliates for underwritings. In these situations, banks were forced to choose between their affiliates' best interests and those of the banks' depositors.

If Glass-Steagall is repealed, conflicts of interest and related investor protection concerns similar to those which led to the enactment of the Act will arise. These concerns will not be fully addressed by the separate affiliate requirement. The Commission's recommendations regarding measures needed to address these investor protection concerns are set forth below.

A. Misuse of Confidential Information

Improper sharing of nonpublic information between banks and their securities affiliates should be prohibited. Both banks and broker-dealers currently must prevent the internal misuse of nonpublic information. Securities firms use methods designed to restrict the flow of information between investment bankers engaged in financings and other transactional work, and traders and analysts. 15/

15/ Most securities firms employ "Chinese Walls" to restrict the exchange of information between investment banking, trading, and investment adviser departments. Other securities firms

(Footnote continued)

Similarly, banks must maintain the separation between their commercial lending operations, their trust and other fiduciary operations, and traders responsible for banks' proprietary accounts.

However, banks have not until recently faced the problem of withholding from an underwriting affiliate information acquired by the bank in the course of extending or monitoring a loan, or screening off from the bank information received by an underwriting affiliate in the course of structuring a securities offering. These new combinations of activities present opportunities for misuse of client information for the benefit of the bank or its securities affiliate.

Existing fiduciary law and antifraud principles may deter the sharing of nonpublic information between a bank and its affiliates, as is generally the case with securities firms. However, in view of banks' extensive access to sensitive corporate information arising from their corporate lending activities, and the new opportunities for misusing this information inherent in trading and underwriting corporate securities, additional restrictions should be placed on the sharing of customer and related information between banks and their securities affiliates. 16/

15/ (footnote continued)

may also use "restricted lists" that list the companies that the firm may be advising in a financial transaction, for which the firm may be underwriting an offering of securities, or with which the firm is negotiating a possible business relationship. Circulated on a regular basis, these lists generally prohibit firm employees from purchasing the listed companies' securities for the firm or themselves and from offering unsolicited recommendations regarding the companies and their securities. To supplement Chinese Walls and restricted lists, some securities firms also have "watch lists" that allow the firms to track the effectiveness of the Chinese Wall and restricted lists. A watch list is used by a firm to monitor trading activity within the firm in securities on the list.

16/ In addition, the Commission believes that, as a matter of good practice, holding companies should establish internal audit units to monitor the activities of the banks, lending affiliates, and underwriting affiliates, in order to ensure that information does not flow improperly among the affiliates, and that nonpublic information is not misused to profit an affiliate, the holding company, or any other person.

S. 1886 partially addresses these concerns by limiting the flow of nonpublic customer information among affiliates. However, the bill allows nonpublic customer information to be shared by a bank, insured institution, or subsidiary with a securities affiliate, and vice versa, if the customer consents. [17] This approach protects institutions from claims that they have shared information without a customer's approval, but does not completely protect against possible abuse of material nonpublic information that the customer has allowed to be communicated for a particular purpose.

Accordingly, Congress may also wish to consider specifically authorizing the agencies that regulate banks, bank holding companies, and securities affiliates to adopt rules requiring these entities to adopt Chinese Wall procedures. This approach was used in S. 1323, proposed tender offer legislation, in which this Committee proposed amending Section 15(c) of the Exchange Act to authorize the Commission to adopt rules and regulations requiring broker-dealers to maintain Chinese Walls.

B. Bank Use of Underwriting to Dispose of Poor Loans

Conflicts of interest that will arise when a securities affiliate underwrites an offering of securities backed by the bank's own assets or the proceeds of which will be used to repay the bank for loans it has extended to the issuer should be addressed. Securitization of assets by affiliated issuers and underwriters raises a potential conflict between the underwriter's obligations to use due diligence in examining the offering and its desire to repay affiliates through a successful offering. Offerings of securities of bank borrowers underwritten by bank affiliates present analogous concerns. Such conflicts may also result in inaccurate disclosure or pricing of the offering and heightened sales pressure during the distribution period.

Similar concerns currently exist with respect to merchant banking, where a broker-dealer may underwrite a securities offering, the proceeds of which are to be used pay off "bridge" loans extended to the issuer by an affiliate of the broker-dealer. The Commission is monitoring this practice.

The federal securities regulations now impose extensive disclosure requirements on all underwritings. The interests of all parties, including the underwriter and its affiliates, must be disclosed. Various provisions also require disclosure by the underwriter to its customers of its potential conflicts in relation to securities it is offering to sell.

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[17] Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph 15(E)(x)).

These disclosure requirements enable investors to assess the conflicts inherent in underwritings conducted on behalf of or to benefit an affiliate. In addition, the NASD has recently proposed amendments to Schedule E of its by-laws to provide additional protections. Schedule E currently requires members distributing their own or their affiliates' securities to have an independent underwriter establish the price of the securities and conduct the necessary "due diligence" review, unless the offering is of investment grade debt or equity securities for which there is an existing, independent market. The NASD has proposed amending the Interpretation of the Board of Governors regarding Schedule E to require an independent underwriter's involvement if ten percent or more of the proceeds of a public offering are directed to NASD members participating in the distribution of the offering. This proposed amendment is designed to cover offerings made to refinance bridge loans extended by a broker-dealer's affiliate.

Requirements of this sort could provide valuable protections where broker-dealers are underwriting securities of, or to benefit, bank affiliates. Similar requirements could be applied to offerings of interests in pools of securitized assets or mortgages of a bank affiliate, or to syndicated loans, such as problem foreign loans. If bank affiliates are allowed to securitize the assets of affiliate banks and underwrite their securities, requirements similar to the NASD's proposal should be applied. 18/

18/ In its recent decisions interpreting Section 20 of Glass-Steagall, the Federal Reserve Board limited underwriting by bank-affiliated broker-dealers of securities backed by consumer receivables and conventional mortgages, to situations in which the underlying assets do not originate from any affiliate of the underwriter. See Order Approving Applications to Engage in Limited Underwriting and Dealing in Consumer Receivable Related Securities [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,021 (July 17, 1987); Order Conditionally Approving Application to Underwrite and Deal in Mortgage Related Securities to a Limited Extent [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,027 (July 17, 1987); Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,957 (Apr. 30, 1987). The Board imposed this limitation based on concerns that the incentives for a conflict of interest would otherwise be substantial, citing specifically "the temptation * * * that the affiliates' least creditworthy assets would be securitized." The Board rejected the argument that these conflicts are adequately addressed by the Commission's disclosure requirements and the NASD's rules.

S. 1886 would require also that a securities affiliate that is underwriting or distributing securities secured by or representing an interest in mortgages or other obligations originated by its affiliate first obtain a rating for the securities from a nationally recognized rating organization, although the rating need not be investment-grade. 19/

C. Placement of Underwritings in Controlled Accounts

Because the potential for conflicts arising out of transactions between bank trust departments and their affiliates will be heightened by expanded bank securities activities, stricter prohibitions respecting bank-affiliate dealings may be needed to prevent banks from placing the interests of the bank and its affiliates ahead of those of its trust customers. For example, a bank could recommend or purchase for its trust accounts securities underwritten by its securities affiliate. This concern has historical precedent. The Senate investigations conducted in the early 1930s chronicled the use of a bank or its trust department as a repository for securities the affiliate could not sell.

Current federal banking law contains some general restrictions against self-dealing. State common law fiduciary standards are also applicable to banks acting as fiduciaries. Under federal banking law, purchases for trust accounts of securities underwritten by a bank or its affiliates are generally prohibited unless authorized by the governing trust instrument, by court order, or by the law of the jurisdiction under which the trust is administered. In addition, the Competitive Equality Banking Act of 1987 added a new Section 23B to the Federal Reserve Act, which prohibits the purchase of securities by the bank, either as principal or fiduciary (during the existence of any underwriting or selling syndicate), from an affiliate that is a principal underwriter of such securities unless a majority of the outside directors of a bank has approved the purchase.

With expanded bank securities powers, these limited safeguards may not be enough. One potential solution would be to prohibit banks from purchasing, in any fiduciary capacity, securities underwritten or dealt in by their securities affiliates or from recommending the purchase of such securities to their customers. The Commission does not recommend this solution, however, because such an approach could injure trust beneficiaries. If a bank's securities affiliate participated in underwritings of major, widely-held corporations, such a broad prohibition might cripple the bank's trust department

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19/ Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(X)).

by reducing the number and quality of issues available for investment by the department. A bank also might be precluded from recommending many highly rated securities to its trust customers. Finally, trust department investment in popular "proprietary" securities products developed and underwritten by a securities affiliate (e.g., stripped zero coupon treasury instruments such as TIGRs or CATS) would be barred. Under the circumstances, this approach might be detrimental to trust department customers as well as to bank trust departments.

The regulatory scheme under the federal securities laws for investment companies and investment advisers demonstrates one approach for dealing with these conflicts of interest. However, the Commission does not recommend that this approach generally be adopted as the regulatory framework for bank-affiliate dealings in this area. Although conflicts of interest in the securities business are addressed generally by the antifraud provisions of the securities laws, 20/ the Investment Company Act of 1940 and the Investment Advisers Act of 1940 contain specific provisions designed to protect investors from the special conflicts of interest that may exist between registered investment companies and their affiliates, and between investment advisers and their clients. 21/ Among the specific provisions of the Investment Company Act are the following:

(1) Section 17(a) generally prohibits an affiliated person or promoter of or principal underwriter for a registered investment company from buying or selling property or securities from or to the investment company unless the Commission approves the transaction (Rules 17a-1 through 17a-8 grant exemptive relief for certain transactions);

(2) Section 17(d) generally prohibits joint transactions between a registered investment company and any affiliated person of or principal underwriter for the company unless the Commission approves the transaction;

20/ The antifraud provisions require that an underwriter that also manages discretionary accounts disclose to its clients "not only that [the underwriter] proposes to deal with them for [its] own account but also of all other facts which may be material to the formation of an independent opinion by the client as to the advisability of entering into the transaction." Securities Exchange Act Release No. 10181 (June 1, 1973).

21/ Common trust funds maintained by banks are excluded from the definition of "investment company" under the Investment Company Act. Generally speaking, registered investment companies are subject to more detailed disclosure provisions under the federal securities laws than are required by the federal banking laws.

(3) Section 10(a) provides that no more than 60% of the board of directors may be interested persons of the investment company;

(4) Section 10(f) generally prohibits an investment company from purchasing securities when an affiliated person is a principal underwriter of the offering except as permitted by Commission rule or order (Rule 10f-3 permits certain investments, subject to price and quality restrictions and percentage limitations on the amount of the offering and the amount of the investment company's assets that are involved); and

(5) Sections 36(a) and (b) authorize the Commission to bring an action against various persons associated with an investment company in the case of breach of fiduciary duty.

Fiduciary principles are incorporated into the Advisers Act, 22/ principally by Section 206. Advisers are fiduciaries who owe a duty of undivided loyalty to their clients and must deal fairly and honestly with them. The duty of fair dealing implies a duty to disclose all relevant information and to avoid, or obtain a client's prior consent to, any conflict of interest. An adviser's fiduciary obligations include best execution, suitability, and exclusive loyalty to the client. In addition, the Advisers Act prohibits an adviser, acting as principal, from buying or selling any security to or from a client without written disclosure to the client and without obtaining the client's consent for each transaction.

In contrast, S. 1886 relies essentially on disclosure, without requiring an indication of understanding or consent. The bill would preclude a bank from recommending a security being sold by its securities affiliate without disclosing that the bank's securities affiliate is selling that security. 23/ This provision does not contain specific consent requirements, perhaps on the assumption that existing federal banking regulations are sufficient. The Commission is concerned that existing bank regulation would permit securities sold by a securities affiliate to be placed in a bank's trust accounts if authorized by the governing trust instruments. Boilerplate language in trust agreements may permit such transactions without further informed consent of trust beneficiaries.

22/ Banks are excluded from the definition of "investment adviser" under Section 202(2)(11)(A) of the Investment Advisers Act.

23/ Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(viii)).

Also, there is little practical experience at this time regarding the operation of Section 23B of the Federal Reserve Act, which was enacted only a few months ago as part of the Competitive Equality Banking Act.

In view of these concerns, current safeguards combined with those provided in S. 1886 may not be adequate to meet all the issues raised by increased bank securities activities. In particular, it may be appropriate to require informed consent of the grantor of the trust or the primary beneficiaries of the trust prior to placement of underwritten securities, or securities in which an affiliate makes a market, in a trust account.

D. Credit to Purchasers of Securities

Bank lending to promote sales of securities by affiliates should be regulated. Through a combination of sales efforts and the provision of credit, a bank could encourage investors to purchase low-quality or otherwise hard-to-sell issues being underwritten by its affiliate. In addition, banks could cause customers to overextend themselves on credit in an effort to unload underwritten issues. The securities laws address these concerns through a temporary prohibition on extending credit for the purchase of underwritten securities. Section 11(d)(1) of the Exchange Act prohibits a broker-dealer from selling, or arranging for the sale of, a security on credit when the broker-dealer is also participating in a new issue distribution of the security. The prohibition extends for 30 days following the completion of the distribution. This prohibition applies when the broker-dealer's temptation to engage in sales promotion is greatest: when selling a new issue of securities during the initial underwriting period.

A similar prohibition should be extended to bank affiliates of broker-dealers. In that regard, the Commission notes that S. 1886 contains a provision that would prohibit a bank from knowingly extending or arranging credit secured by, or for the purpose of purchasing, any security that is underwritten by a securrities affiliate during the underwriting period and for a period of 30 days thereafter. 24/

24/ Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(iv)). It may be appropriate to amend this provision to provide expressly that banks have an affirmative obligation to verify that loans are not being used to purchase securities underwritten by the bank.

A related issue is margin regulation. Margin regulation is an area of particular concern because of the recent volatility in the securities markets. The existing margin regulations promulgated by the Federal Reserve Board that are applicable to banks and broker-dealers contain regulatory disparities that do not take into account the increased securities activities of bank affiliates.

Section 7 of the Exchange Act grants to the Federal Reserve Board the authority to adopt rules and regulations to prevent the excessive use of credit in connection with the purchase or carrying of securities. 25/ Under Section 7, the Federal Reserve Board has promulgated Regulation T, applicable to registered broker-dealers, and Regulation U, applicable to banks.

As a general matter, banks and securities firms lending funds to customers to be secured by "margin" securities or for the purpose of purchasing or carrying "margin" securities are subject to the same numerical margin requirements. However, securities firms are regulated more stringently under Regulation T than banks are regulated under Regulation U. Regulation T essentially limits the kinds of securities broker-dealers can extend credit on to margin securities (*i.e.*, listed equities and certain approved over-the-counter stocks). Under Regulation U, banks can loan money for a broader range of securities purchases and are accorded more flexible collateral requirements. 26/ Regulation U does not apply to purchases of non-margin stock; nor does it apply when the collateral used is other than stock even if the purpose of the loan is to purchase margin stock. In addition, banks can make unsecured loans for the purpose of purchasing securities. 27/

25/ Section 7 does not apply to exempted securities.

26/ Section 7(d) of the Exchange Act grants the Federal Reserve Board broad authority to regulate *any* bank loan for the purpose of purchasing or carrying *any* security (except a loan "on a security other than an equity security"). However, Regulation U as promulgated by the Federal Reserve Board is more limited in scope and applies only to extensions of credit by banks on "margin stock" for the purpose of purchasing or carrying "margin stock."

27/ Securities margin loans made by a bank to customers of its securities affiliate could be governed by Regulation T (not Regulation U) if the broker-dealer arranged the loans from its affiliated bank.

These disparities in margin regulation may have been rationally-based when banks were engaged solely in a general lending business and were influenced only by normal lending considerations. However, as banks become more heavily involved in the securities business, both by directly acting as broker-dealers and by owning securities affiliates, any basis for the different treatment accorded banks and broker-dealers engaged in essentially the same activities is undercut. Bank extensions of credit to customers purchasing securities in transactions in which the bank (or its affiliate) is an active participant should be regulated as securities functions and in a manner comparable to broker-dealers.

E. Disclosure

Securities affiliates and banks must be required to make plain to customers that the securities affiliate of a bank is a separate entity from the bank itself, and that the securities that are sold, offered, or recommended by the securities affiliate are not guaranteed by the bank or by federal deposit insurance. To address this problem, S. 1886 would require that bank securities affiliates provide potential customers with disclosure statements clarifying the affiliate's separate status, pursuant to regulations promulgated by the Commission. 28/ The Commission believes this safeguard is appropriate.

VI. THE HOLDING COMPANY STRUCTURE

A. The Proposals of S. 1886 and S. 1891

S. 1886 generally would require that expanded securities activities of banks be placed in subsidiaries of holding companies; they could not be conducted in the banks themselves, nor in the banks' subsidiaries. Under S. 1886, the Federal Reserve Board would have oversight authority over the holding company, including oversight over transfers of capital. S. 1886, however, would limit the Board's authority over those bank holding companies deriving 80% or more of their revenues from, and devoting 80% or more of their assets to, securities activities. For these entities, the Board could not conduct examinations, require periodic reports, or set capital requirements. S. 1891 would establish three categories of holding companies: bank holding companies; financial holding companies; and commercial holding companies. Each category of holding company would be authorized to engage in a different range of securities, banking, and commercial activities. The Financial Services Oversight Commission, to be created under the bill, would have authority to determine permissible activities for each type of holding company.

28/ Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(vii)).

The Commission agrees generally that securities activities should be placed in affiliates that are subsidiaries of holding companies, rather than subsidiaries of banks. 29/ The holding company structure has advantages over alternative structures, especially where the affiliate is engaged in corporate underwriting and dealing. First, under a holding company structure, the effect on an insured bank's capital would be less if its securities affiliate were to suffer financial difficulties than if the securities affiliate were a subsidiary of the bank. Similarly, under this structure, losses by a bank would be less likely to threaten the solvency of a securities affiliate.

Second, the holding company structure provides greater corporate separation between the securities affiliate and the bank. This will reduce the risk that the corporate veil will be pierced, resulting in the bank being held liable for the obligations of a securities affiliate. However, in the event of a failure of one subsidiary within the holding company structure, principles of equitable subordination, pension fund and tax liability of each member of the consolidated group, and controlling person liability could still cause liability to be shifted from one subsidiary within the holding company to another.

The Commission recognizes that creating a holding company imposes certain costs for small banks that do not currently have a holding company structure and may reduce their flexibility. In addition, the need for the additional insulation between a bank and a securities affiliate is less pressing where the securities affiliate is not engaged in corporate underwriting and dealing. For these reasons, it may be appropriate to allow a small bank to conduct its existing securities activities and underwriting and dealing in municipal securities (including municipal revenue bonds) in a subsidiary of the bank, so long as that subsidiary is subject to Commission regulation.

29/ To facilitate holding company formation, Section 202 of S. 1886 would exempt such transactions from the registration requirements of the Securities Act of 1933. This exemption would be limited to transactions in which bank shareholders receive the same proportionate interest in the holding company. In 1984, the Commission endorsed a similar provision in a bill that would have expanded bank securities powers.

B. The Limited Exemption for Holding Companies Primarily Engaged in Securities Activities

The Commission believes that further consideration should be given to the limited exemption from holding company regulation in S. 1886 for holding companies primarily engaged in securities activities. Currently, that exemption is keyed to the relatively large size of a holding company's securities activities instead of the relatively small size of the holding company's banking activities. Because the Bank Holding Company Act's provisions are concerned primarily with the safety and soundness of banks, a holding company should only be fully subject to that Act where the company's banking activities are substantial. Accordingly, the Commission recommends that the limited exemption should apply to those holding companies that devote less than a certain percentage of their assets to, and derive less than a certain percentage of their income from, banking activities. Otherwise, a holding company that was primarily engaged in securities activities and also had significant subsidiaries engaged in other permissible nonbanking activities (such as certain insurance activities or commodity futures brokerage) could become subject to full Bank Holding Company Act regulation even if its banking activities were de minimis.

Moreover, those holding companies that qualify for the limited exemption will continue to be subject to the Bank Holding Company Act's restrictions on permissible nonbanking activities. Most existing securities firms therefore will be unable to affiliate with banks without divestiture of their insurance, real estate or other operations.

C. Role of Holding Company Regulation

S. 1886 would give to the Federal Reserve Board and S. 1891 would give to the Financial Services Oversight Commission substantive authority to regulate certain holding companies that have securities subsidiaries. If such regulatory authority is deemed necessary, the holding company regulator should be directed to coordinate with the Commission and to consider not only the safety and soundness of banks and the banking system, but also concerns related to orderly securities markets, the protection of the SIPC fund, and investor protection. Moreover, a holding company regulator should have no authority to regulate the activities of a holding company's securities subsidiaries or to affect the Commission's authority to require full disclosure by publicly-owned holding companies through the securities registration and reporting requirements.

Finally, the Commission believes that the creation of an additional financial regulator, as proposed in S. 1891, is unnecessary and that the proposed structure of the Financial Services Oversight Commission is unwieldy and impractical.

VII. CONCLUSION

The Commission is unable to support repeal of Glass-Steagall unless adequate safeguards are established to address the serious investor protection concerns raised by repeal. These safeguards include requiring banks to perform their existing and new securities activities in separate affiliates, subject to Commission regulation, and amending the Investment Company Act and Investment Advisers Act to address the concerns created by bank entry into investment company activities. In addition, the securities registration and reporting requirements of the securities laws should be consolidated within the Commission for all publicly-owned banks and thrifts. Congress should also consider providing additional safeguards to protect against other conflicts of interest and related investor protection concerns.

The Commission would be pleased to work with the Committee to implement the changes recommended in this statement in the legislation now being considered by the Committee.

II

100TH CONGRESS
1ST SESSION

S. 1175

To amend the Securities Exchange Act of 1934 to ensure that all participants in the Nation's securities markets are equally regulated, to promote fair competition among those providing essentially identical services, and to ensure adequate protection for all investors.

IN THE SENATE OF THE UNITED STATES

MAY 8 (legislative day, APRIL 21), 1987

Mr. D'AMATO introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 to ensure that all participants in the Nation's securities markets are equally regulated, to promote fair competition among those providing essentially identical services, and to ensure adequate protection for all investors.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—DEFINITIONS OF BROKER AND DEALER

SEC. 101. DEFINITION OF BROKER.

Section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) is amended to read as follows:

"(4)(A) The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but such term does not include a bank except as provided in subparagraph (B) of this paragraph.

"(B) The term 'broker' includes any bank that (i) publicly solicits brokerage business, (ii) receives transaction-related compensation for brokerage services provided to trust, managing agency, or other advised accounts, or (iii) underwrites securities on an agency basis, except that a bank is not a broker if it restricts its activities to transactions in exempted securities.".

SEC. 102. DEFINITION OF DEALER.

Section 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(5)) is amended to read as follows:

"(5)(A) The term 'dealer' means any person engaged in the business of purchasing and selling securities for his own account, through a broker or otherwise, but such term does not include a bank, except as provided in subparagraph (B) of this paragraph, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

"(B) The term 'dealer' includes any bank that (i) publicly solicits securities transactions to be effected on a principal basis, whether in a riskless principal capacity or otherwise, (ii) receives transaction-related compensation for effecting transactions in securities on a principal basis for trust, managing agency, or other advised accounts, or (iii) deals in or underwrites securities, except that a bank is not a dealer if it restricts its activities to transactions in exempted securities.".

SEC. 103. POWER TO EXEMPT FROM THE DEFINITIONS OF BROKER AND DEALER.

Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78(c)) is amended by adding at the end thereof the following:

"(e) The Commission, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt banks from the definitions of 'broker' or 'dealer' if the Commission finds that such exemption is consistent with the public interest, the protection of investors, or the purposes of this title.".

SEC. 104. REQUIREMENT THAT BANKS FALLING WITHIN THE DEFINITIONS OF BROKER OR DEALER PLACE THEIR SECURITIES ACTIVITIES IN A SEPARATE CORPORATE ENTITY.

Section 15(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78) is amended to read as follows:

"SEC. 15. (a)(1) It shall be unlawful for any broker or dealer that is either a person other than a natural person or a natural person not associated with a broker or dealer that is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

"(2) It shall be unlawful for any bank to act as a broker or dealer, except on an exclusively intrastate basis or in transactions in exempted securities, municipal securities, or commercial paper, bankers' acceptances, or commercial bills. This section does not preclude a bank subsidiary or bank holding company affiliate, which is separate from the bank and is registered in accordance with subsection (b) of this section, from engaging in securities activities to any extent otherwise permissible by law.

"(3) The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraphs (1) and (2) of this subsection any broker or dealer or class of broker or dealer specified in such rule or order.".

TITLE II—SAVINGS PROVISIONS AND EFFECTIVE DATES

SEC. 201. JURISDICTION OF FEDERAL BANKING REGULATORS.

Nothing in this Act affects the statutory provisions of the Act known as the Glass-Steagall Act, 1933 (12 U.S.C. 24, 377, 378, 78) or the jurisdiction of the Office of the Comptroller of the Currency or the Board of Governors of the Federal Reserve System to enforce the provisions of such Act.

SEC. 202. GENERAL EFFECTIVE DATES.

This Act shall take effect 180 days after the date of enactment of this Act.

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SECURITIES AND EXCHANGE COMMISSION

Statement in Support of Proposed Amendments to Modify the Definitions of Broker and Dealer in the Securities Exchange Act of 1934

Introduction

The Securities and Exchange Commission ("Commission") is submitting to Congress proposed amendments to the definitions of "broker" and "dealer" contained in sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 [1] (the "Act" or the "Exchange Act"). The proposed amendments are necessary to address the increased involvement of banks in the securities business. Absent these amendments, banks which are engaged in securities activities which are indistinguishable from those of brokers and dealers will remain outside of the Commission's regulatory jurisdiction. These amendments are designed to achieve regulation by function rather than by outmoded industry classification. The proposed amendments will ensure that all entities engaged in the securities business will be subject to the regulatory scheme for broker-dealers that Congress has established and charged the Commission with administering. [2] The Commission believes that these amendments are necessary to maintain its ability to meet

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[1] 15 U.S.C. § 78a *et seq*.

[2] Section 2 of the Exchange Act, 15 U.S.C. § 78b.

its statutory responsibilities of ensuring fair competition among participants in the securities business and the maintenance of fair and honest securities markets.[3]

The proposed amendment to section 3(a)(4) of the Act would modify the blanket exception for "banks" [4] from the definition of "broker." [5] Similarly, the proposed amendment to section 3(a)(5) would modify the blanket exception for banks from the definition of "dealer." [6] Banks that (1) publicly solicit brokerage business, (2) receive transaction related compensation for providing brokerage services to advised accounts, or (3) deal in or underwrite securities, would no longer be exempt from the definitions of "broker" or "dealer." However, a bank would retain an exception from the definitions if it limited its securities activities to transactions in exempted securities. 7/ The amendments would require banks that fall within the definitions of "broker" or "dealer," to establish separate entities registered as broker-dealers with the Commission, through which securities activities would be carried out.

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[3] Section 11A(a)(1)(c)(ii) of the Exchange Act, 15 U.S.C. § 78.

[4] Section 3(a)(6) of the Exchange Act (15 U.S.C. § 78c(a)(6)) defines "bank" as:

> (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising a fiduciary power similar to those permitted to national banks under section 11(k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

[5] Section 3(a)(4) of the Exchange Act (15 U.S.C. § 78c(a)(4)) defines "broker" as: "any person engaged in the business of effecting transactions in securities for the accounts of others but does not include a bank" (emphasis added).

[6] Section 3(a)(5) (15 U.S.C. § 78c(5)) defines "dealer" as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business" (emphasis added).

A new section to the Securities Exchange Act is also proposed. Section 3(e) would provide the Commission with authority to exempt banks, by rule or by order, from the definitions of "broker" or "dealer," where the Commission determines that such an exemption is consistent with the public interest. 8/

Discussion

A. The Current Exception from the Definitions of Broker and Dealer for Banks

Under the current statute, banks are expressly excluded from the definitions of "broker" and "dealer." The exceptions in sections 3(a)(4) and 3(a)(5) of the Exchange Act thus permit banks

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7/ Section 15(a) contains an exception for brokers and dealers that engage exclusively in transactions in exempted securities.

8/ This proposal is not intended to express any view as to the legality under banking law of present bank securities activities or those activities in which banks or other financial institutions seek to engage.

to engage in both agency and principal securities transactions with customers to whatever extent is permitted by banking law without registering with the Commission as brokers or dealers.

The exceptions for banks in sections 3(a)(4) and 3(a)(5) were introduced in the original bill proposing regulation of the nation's securities markets in order to reduce, as much as possible, the impact of the bill upon the nation's banks, which were expected to be foreclosed from the majority of the securities business very soon thereafter. 9/ Under the initial interpretations of the Glass-Steagall Act, which became effective just after enactment of the Exchange Act, banks were limited to securities activities carried out without recourse to the bank and for or on the order of customers only. 10/ Congress excepted banks from the definitions of broker and dealer because it concluded that the *de minimis* accommodation services provided at the time by a limited number of banks were insignificant in the greater scheme of the nation's securities markets.

9/ See *Stock Exchange Regulation Hearing on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce*, 73rd Cong., 2d Sess. 86 (Feb. 16, 1934) in which Thomas G. Corcoran, an administration spokesman and principal drafter of the Exchange Act, explained that banks should be excluded from the definitions of broker and dealer because of "the limitations on banks" imposed "under the Glass-Steagall bill." Specifically, he noted that "[a] bank cannot normally go in the business, like a broker, of dealing in securities." *Id.*

10/ *See* Section 16 of the Glass-Steagall Act, 12 U.S.C. 24 (1986).

As bank securities activities began in time to change, the Securities Acts Amendments of 1975 11/ mandated that the Commission conduct "a study of the extent to which persons excluded from the definitions of "broker" and "dealer" maintain accounts on behalf of public customers for buying and selling securities registered under Section 12 of [the Exchange Act] and whether such exclusions are consistent with the protection of investors and the other provisions of [the Exchange Act.]" 12/ In 1977, the Commission submitted to Congress three reports on bank securities activities. 13/ In these reports, the Commission recognized that banks were providing brokerage services and engaging in other securities activities. The Commission refrained, however, from taking the position at that time that banks should be required to register as broker-dealers. The Commission noted in the Bank Study that banks handled a relatively low average number of orders and that banks did not engage in any substantial advertising effort to solicit customers from the general public. 14/ The Commission explicitly stated, however, that changes in the markets might affect the conclusions expressed in the Bank Study. 15/

11/ Pub. L. No. 94-29 (June 4, 1975), 89 Stat. 97 (1975).

12/ Section 11A(e) of the Exchange Act, 15 U.S.C. 78k-1(e)(1986).

13/ Reports on Bank Securities Activities, 95th Cong., 1st Sess. (1977) ("Bank Study"). The Commission submitted an Initial Report on January 3, 1977, a Second Report on February 3, 1977 and a Final Report on June 30, 1977.

14/ Bank Study Final Report at 21.

15/ Bank Study Final Report at 43.

B. Recent Changes in the Nature and Volume of Bank Securities Activities

Banks have engaged in limited securities activities since the Glass-Steagall Act, 16/ enacted in 1933, strictly limited the extent to which single or related entities could engage in commercial banking and securities underwriting simultaneously. However, since 1982, the barriers to concurrent commercial banking and securities activities have been significantly eroded as a result of new interpretations of the Glass-Steagall Act by federal banking regulators. Securities brokerage services provided on a retail basis are now commonplace in commercial banks, or through their affiliates. 17/ More recently, the provision of brokerage services coupled with investment advisory services through a single commercial bank-affiliated entity has been approved by both the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency. 18/

16/ 12 U.S.C. §§24, 377, 378, and 78 (1986).

17/ *See* Approval by the Board of Governors of the Federal Reserve System for Bank of America to acquire Charles Schwab & Co., 69 Fed. Res. Bull. 105; 12 C.F.R. 225.25(b)(15). *See also* Decision of the Office of the Comptroller of the Currency regarding Security Pacific Bank's establishment of a subsidiary to engage in brokerage activities [1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶99,284 (Aug. 26, 1982); FDIC General Counsel's Opinion No. 6 -- Legality of Discount Brokerage Services When Offered by Insured Non-Member Banks, 84 F.R. 22989 (May 23, 1983).

18/ *See* Decision of the Board of Governors of the Federal Reserve System approving National Westminister Bank's application to provide brokerage services and investment advisory services, [Current Matters] Fed. Banking L. Rep.

(footnote continued)

The staff of the Board of Governors of the Federal Reserve System has also approved the sale by a securities affiliate of a bank holding company of its customer list to the underwriter of a newly organized closed-end mutual fund in exchange for a fixed fee. 19/ Recently, the Board of Governors of the Federal Reserve System also approved an application by a bank holding company to permit its bank subsidiary to engage in commercial paper placement activity. 20/

18/ Footnote Continued

(CCH) ¶86,610 (October 23, 1985). *See* letter from Judith A. Walter, Senior Deputy Comptroller for National Operations, Office of the Comptroller of the Currency to R.C. Gallagher, President, Kellogg-Citizens National Bank (April 16, 1986).

19/ *See* Letter from Michael Bradfield, General Counsel, Board of Governors of the Federal Reserve System, to Margery Waxman, Esq., Sidley & Austin (June 5, 1986).

20/ *See* Statement Concerning Applicability of the Glass-Steagall Act to the Commercial Paper Activities of Bankers Trust Company [1984-1985 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶86,270 (June 4, 1985). See also *SIA v. Board of Governors of the Federal Reserve System* No. 86-5139 (D.C. Cir. December 23, 1986) in which the Board's approval of these activities was judicially upheld. The Court of Appeals for the District of Columbia Circuit has also recently upheld a regulation adopted by the Federal Deposit Insurance Corporation in 1984 that permits insured banks that are not members of the Federal Reserve System to establish or acquire affiliates to engage in, among other things, securities underwriting and dealing activity. See *Investment Company Institute and Securities Industry Association v. FDIC*, No. 84-1616 (D.C. Cir. Jan. 16, 1987), approving promulgation of 12 CFR 337.4, Securities Activities of Subsidiaries of Insured Nonmember Banks: Bank Transactions with Affiliated Securities Companies, 49 F.R. 46709 (November 28, 1984). Cf. Order Approving Application to Underwrite and Deal in Commercial Paper to a Limited Extent [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶86,912 (March 18, 1987), in which the Board authorized The Chase Manhattan Corporate to establish an affiliate to underwrite and deal, as principal, in third party commercial paper to a limited extent.

Both the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency have conditioned most of their recent decisions expanding banks' securities activities on the conduct of those activities in entities registered with the Commission. 21/ Absent enactment of the proposed legislation, however, there can be no assurance that widespread securities activities will be effected through registered broker-dealers only.

The Commission observed in 1985 that "bank brokerage activities and related promotional efforts have changed substantially since 1977." 22/ The Commission noted that bank employees were taking orders and forwarding them to clearing brokers in exchange for part of the commission paid by the customer. Also, banks were soliciting members of the public to become "brokerage" customers of the bank through extensive and aggressive advertising campaigns. 23/

The Commission concluded that banks were no longer merely providing accommodation services to existing customers, but instead, were promoting services that were "functionally indistinguishable from those offered by registered broker-dealers."

21/ The exception for banks in the definition of "broker" and "dealer" is not available to non-bank affiliates of banks or bank holding companies.

22/ Securities Exchange Act Rel. No. 22205 (July 1, 1985), 50 F.R. 28385, 28386.

23/ Id.

The Commission also noted that the number of banks engaging in these activities had increased substantially since 1977. 24/

In July 1985 the Commission adopted Rule 3b-9, a rule intended to ensure adequate and consistent regulation of securities activities of banks. 25/ This rule required any bank engaged in the business of effecting brokerage transactions, or dealing in or underwriting non-exempted securities as defined in the Exchange Act, 26/ to either register as a broker-dealer or enter into a contractual or other relationship under which a registered broker-dealer would in fact be the provider of such services. In response to the Commission's request for comments on proposed Rule 3b-9, sixty-one of the one hundred eighty-six banks that commented on the rule indicated that they were engaged in brokerage business to some extent. 27/ Following the Commission's adoption of Rule 3b-9 on July 1, 1985, at least 170 banks and bank holding companies have now established registered broker-dealer subsidiaries. Also, a substantial additional number of

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24/ *Id.*

25/ *Id.*

26/ *See* Section 3(a)(12) of the Exchange Act, 15 U.S.C. § 78c(a)(12).

27/ Rule 3b-9 was proposed on November 8, 1983 in Securities Exchange Act Release No. 20357, 48 F.R. 51930 (1983). The comment period on the rule proposal ran through January 15, 1984. During that period over 270 comment letters were submitted to the Commission.

banks have chosen to enter into contractual arrangements with independent broker-dealers in order to offer securities services to the public.

The breadth of the securities activities currently carried out by banks became apparent to the Commission staff ("staff") in the course of administering Rule 3b-9. During the life of the rule, the staff received inquiries regarding a variety of securities services provided by banks that directly paralleled broker-dealers' services. These included extensive marketing of unit investment trust and mutual fund shares through bank bond departments, and banks trading securities for custodial and advised accounts through their own trading desks, in addition to discount brokerage and advised account services.

The Court of Appeals for the District of Columbia Circuit held, on November 4, 1986, that the Commission did not have authority to promulgate Rule 3b-9. 28/ The Court of Appeals was sympathetic to goals which the Commission was seeking to achieve and suggested that the appropriate course would be for Congress to address the issue. The Commission continues to believe that, consistent with the statutory objective of ensuring fair competition among participants in the securities markets, all entities engaged in the securities business should be subject to the same

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27/ *See American Bankers Association v. Securities and Exchange Commission* 804 F.2d 739 (D.C. Cir. 1986).

regulatory scheme that Congress established for broker-dealers and charged the Commission with administering. 29/

The Commission believes that the active securities business now occurring in banks beyond the Commission's statutory jurisdiction raises substantial investor protection concerns. The Commission administers a coordinated system of regulation of securities activities that is designed specifically to assure that investors are adequately protected through full disclosure and the prevention of unfair and inequitable practices in the securities markets. Broker-dealer registration is an important element of this regulatory system. As banks expand both the volume and range of their securities activities, 30/ the absence of a requirement that their securities activities be carried out in a registered broker-dealer substantially undermines the Commission's regulatory system and creates regulatory disparities. The regulation of bank securities activities under federal banking law is an inadequate substitute for Commission regulation. Federal banking law has as its primary purposes the protection of depositors and preservation of the financial soundness of the banks, not the protection of investors and fairness of securities markets. The Commission believes that

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29/ Section 11A(a)(1)(c)(ii).

30/ *See* Norton, "Unleashing Banks on Wall Street," Fortune 99 (September 29, 1986).

bank securities activities must be brought within the structure of laws, rules, and regulations designed by Congress, the Commission and the self-regulatory organizations to ensure complete and effective regulation of the securities markets, investor protection, and the maintenance of fair and orderly markets.

The Exchange Act, and the rules promulgated thereunder, impose on broker-dealers registered with the Commission extensive net capital, books and records, and customer protection rules, systematically designed to protect investors. Additional rules are imposed by the self-regulatory organizations, such as the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc., that registered broker-dealers are required to join. Compliance with these rules, and federal securities laws generally, is monitored by the Commission, as well as the self-regulatory organizations. The statute and regulations provide for regular inspections by examiners specially trained to detect violations of the federal securities laws. In addition, registered broker-dealers may only employ persons who have passed examinations demonstrating their knowledge of the federal securities laws and the securities markets. Registered broker-dealers and their employees are required to know the federal securities laws, and have a responsibility to refrain from engaging in illegal conduct either on behalf of or vis-a-vis their customers. Also, the Securities Investor Protection

Corporation ("SIPC") protects the funds and securities of customers of registered broker-dealers up to $500,000 (including $100,000 in cash).

Regulation by function would ensure that all participants in the securities markets would be subject to the regulatory system, established by Congress and implemented by the Commission and the self-regulatory organizations, which the Commission considers to be the best mode of regulation for the securities activities of financial institutions. Regulation by function also will help ensure fair competition among banks and broker-dealers. Congress has implemented several joint regulatory systems, including trading in municipal and government securities, where the Commission and the bank regulators share inspection and enforcement authority; however, in each of these systems registration standards and rulemaking are not shared but are centrally located. The Commission believes that broker-dealer registration, and the regulation that follows, should be uniformly applied to all entities engaged in securities activities, whether banks or non-banks, on a central basis by the Commission in order to further the implementation of regulation by function.

C. Proposed Amendments to Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act; Proposed Section 3(e) of the Securities Exchange Act

In order to bring bank securities activities within the established system of regulation for such activities, and to ensure that the securities activities of all financial institutions are regulated consistently, the proposed legislation would modify the exceptions for banks currently found in

The CHAIRMAN. Well, thank you, Mr. Ruder. I'm delighted to hear you say that. I agree with you that Senator D'Amato has made a very useful suggestion and I am very sympathetic to it.

Mr. Seidman.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORP.

Mr. SEIDMAN. Thank you, Mr. Chairman. Good morning, members of the committee. I am pleased to testify today on financial services reform legislation. We would like to express our appreciation to you, Mr. Chairman, and Senator Garn, as well as Senators Wirth, Graham, Cranston, and D'Amato, for advancing the reform process through the introduction of financial restructuring measures.

I also would like to commend and support generally the views expressed by my fellow witnesses. I think never have so many regulators agreed on so much with so much turf, economic and bureaucratic, involved.

The FDIC's overall views on reform and structure of the financial services industry are set forth in our study, a copy of which I think has been submitted to all of you, and I have also submitted a copy today for the record.

The major conclusions of that study are described briefly in my written testimony which I would also request be a part of the record.

The CHAIRMAN. Without objection, so ordered.

[The publication referred to may be found in committee files.]

PROXMIRE-GARN BILL

Mr. SEIDMAN. I would like to begin my comments on S. 1886 by thanking both Chairman Proxmire and Senator Garn for considering the views of the FDIC in developing their bill.

We view the repeal of the affiliation restrictions of Glass-Steagall that are contained in S. 1886 as a sound first step in enhancing the competitiveness of the financial services industry.

We are pleased to see that the bill covers three of the most important aspects of financial restructuring in our view—bank insulation, functional regulation, and concentration.

Banks must be insulated for safety and soundness if they are permitted to affiliate with securities firms or any other type of financial or nonfinancial entity. S. 1886 contains extensive insulation mechanisms that seem to be appropriate and not too burdensome.

While we question the need for the total prohibition in S. 1886 against virtually all transactions with securities affiliates and believe that over time they may be relaxed, at least at the outset it may be prudent to overinsulate the bank and, thus, we support these provisions.

We are concerned, however, with the encroachment on States' rights that would occur by permanently eliminating the Glass-Steagall exemption for State-chartered nonmember banks and particularly in terms of where this may be applied in other areas. This exemption was recently confirmed by the U.S. Supreme Court. We believe, as Secretary Gould does, that the committee should consider seriously whether the preemption is necessary in view of the strong insulation measures contained in the bill.

The FDIC believes that functional regulation is critical to any financial restructuring measure. We applaud the movement in that direction reflected in the bill.

For the most part, the bill would house the regulation and supervision of bank securities affiliates in the appropriate regulator, the SEC.

Numerous other specific comments on the bill are contained in my written testimony and I will not reiterate those here. However, I would like to address the concentration limitations contained in the bill.

We agree that antitrust laws may not be sufficient to deal with interindustry affiliations such as those between banking and securities firms. We have no objection to the approaches taken in the bill prohibiting affiliations between very large firms, but comparable rules must be considered with respect to foreign corporations or we will be restricting our own corporations without restricting their worldwide competitors.

WIRTH-GRAHAM BILL

We also would like to thank Senators Wirth and Graham for the introduction of S. 1891. We concur with the two primary goals of that legislation—permitting banks to affiliate with firms engaged in all forms of financial activities, and providing a mechanism for coordinating the regulation of all financial service providers.

However, we believe that that bill moves in the wrong direction in achieving those goals. Rather than developing the simplest and least costly regulatory structure, S. 1891 would establish a new megabureaucracy. It would involve substantially greater Federal regulation of all types of nonbanking activities but virtually no improved regulation of the supervision of banks.

We believe the focus of Government regulation and financial restructuring should be on federally insured banks and not on all those entities that may be permitted to affiliate with banks.

S. 1891 also would establish a new transfer system corporation and we believe there is no need for another agency to oversee the Nation's payments system.

While the bill introduced by the Chairman and Senator Garn provides a good first step in financial restructuring, we find significant appeal in the more comprehensive approach taken in the bill introduced by Senators D'Amato and Cranston.

While we have not had an opportunity to analyze S. 1905 in detail, from our first review we believe it provides appropriate additional bank regulation while allowing freer competition in the financial system as a whole.

Of course, political judgments must determine whether this kind of comprehensive approach to restructuring can be accomplished at this time, as Senator Dixon pointed out in his opening statement.

It may be feasible and perhaps wise to take only the first step now; namely, the step reflected in S. 1886. However, we believe that S. 1905 provides the appropriate framework for the future of the financial services industry and thus merits close examination by the committee.

D'AMATO-CRANSTON BILL

I would now like to address some of the specific aspects of S. 1905 since it had not been introduced when our written statement was prepared.

The bill provides improved regulation and supervision, where the focus should be in our opinion, on federally insured depository institutions. New insulation mechanisms for banks are established by the bill which in many respects are the same as those in the chairman's bill. Thus, like the chairman's bill, the D'Amato-Cranston measure establishes the type of supervisory wall that provides adequate insulation of banks, thereby permitting them to affiliate safely with virtually any type of nonbanking activity.

It also contains new criminal and civil penalties for violation of the insulation mechanisms. We believe that penalties such as these are an extremely important element to any banking insulation program.

However, we question the necessity for the provision in S. 1905 that requires additional capital for banks that are affiliated with nonbanking entities. Additional bank capital should not be necessary if an adequate supervisory wall is constructed.

Furthermore, given adequate insulation, banks ought to be able to own a nonbanking entity as well as be owned by one, and that is the point that Comptroller Clarke made. S. 1905 should make clear the bank subsidiary route is a permissible one for banks.

S. 1905 goes the furthest of all the bills in the area of functional regulation. It leaves the existing regulatory structure for banks and all other entities in place. It explicitly prohibits bank regulators from regulating the capital of the new depository institution holding companies and their affiliates. Functional regulation is further reflected in the fact that it requires all securities, insurance and real estate activities to be moved out of the banks and into affiliates. While that may be important to assure complete functional regulation in a fully restructured environment, it may be necessary to consider whether there should be some grandfathering or de minimis exceptions.

S. 1905 also would establish a new National Financial Services Committee. In contrast to the new agency contained in S. 1891, however, it does not appear to be a new bureaucracy that results in new layers of regulation and cost. Instead, it is a mechanism for coordination among existing agencies during times of financial crisis as well as for day-to-day policy decisions. This would seem to be an appropriately expanded mechanism once the new structure is in place for addressing the types of issues now within the jurisdiction of the Exam Council.

Finally, I want to express our strong opposition to any extension of any part of the moratorium that is now set to expire in March.

In conclusion, we find meritorious positions in each of the bills. We support S. 1886 as a good first step in the financial system's reform, and we believe that S. 1905 provides the appropriate approach for long-range restructuring. There is an urgent need to act now and we stand ready to help the committee in any way we can.

[The complete prepared statement of L. William Seidman follows:]

the definitions of "broker" and "dealer" in sections 3(a)(4) and 3(a)(5) of the Exchange Act. The effect of modifying this exception will be to include banks engaged in (1) publicly soliciting brokerage business, (2) receiving transaction-related compensation for brokerage services provided to advised accounts, or (3) dealing in or underwriting securities, in the group of entities that are subject to the definitions of "broker" and "dealer."

This proposed legislation embodies the general concepts of Rule 3b-9. Rule 3b-9 contained the basic provisions proposed for inclusion in sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act. Exemptive authority similar to that proposed as section 3(e) was also in Rule 3b-9. Rule 3b-9, however, also included numerous express exceptions that the proposed legislation does not include. During the time that Rule 3b-9 was in effect, the Commission received many requests for exemptions for activities the scope of which went beyond the express exceptions. The Commission considers the inclusion of express exceptions in the proposed legislation unnecessary. The proposed legislation, however, would introduce section 3(e) of the Exchange Act, empowering the Commission to exempt banks by rule, regulation, or order, from the definitions of "broker" or "dealer", either unconditionally or subject to certain terms or conditions. The Commission would also retain the authority to exempt banks from the requirements of section 15(a) of the Exchange Act.

The Commission considers the authority in these provisions sufficient to ensure that activities that might fall within the terms of the statutory provisions, but are more appropriately exempted from Commission oversight as traditional banking activities, are adequately protected from unnecessary regulation.

Subject to an evaluation of the continuing evolution of bank securities activities, the Commission would expect to engage in exemptive rulemaking generally consistent with the exceptions included in Rule 3b-9. In particular, the Commission anticipates that exemptive authority would be used to adopt rules exempting from the definitions of "broker" and "dealer" banks engaged in solely traditional customer accomodation transactions, certain trust department activities and custodial functions historically performed by banks, and entities subject to section 15(e) of the Exchange Act. Moreover, such rules could exempt securities-related activities the Commission determined did not constitute securities "broker" or "dealer" activities, even if the activities appeared to come within the letter of the definitions. For example, the Commission anticipates using this authority to exempt a bank that entered into a so-called "networking" arrangement, under which the bank enters into a contractual agreement with a registered broker-dealer and the broker-dealer provides the brokerage service. The bank and its employees would be limited under such an exemption to providing only clerical and ministerial services. However, pursuant to the agreement, the bank would be entitled to receive a portion of the broker-dealer's commissions generated by customers directed to the broker-dealer by the bank. 31/

The proposed legislation would continue to include express exceptions in sections 3(a)(4) and 3(a)(5) for banks that limit their securities brokerage and dealing business to transactions in exempted securities, as defined in the Exchange Act. These exceptions will allow banks that limit their securities activities to transactions in exempted securities such as municipal or government securities, which are already subject to a statutory scheme of regulation and specialized dealer registration, to remain outside of the body of persons defined as brokers and dealers. 32/

31/ The Division of Market Regulation has issued no-action letters to savings institutions on the basis of similar arrangements. See, e.g., letter from Susan J. Walters, Branch Chief, Division of Market Regulation, SEC, to Lance Becker, Esq. (June 12, 1986); see also letter from Jeffrey Steele, Associate Director, Division of Market Regulation, SEC, to Thomas A. Russo, Esq. (July 8, 1982).

32/ Section 15B of the Exchange Act outlines the procedures under which a bank, or its separately identifiable department engaged in municipal securities dealing activities, must register with the Commission, and authorizes the Municipal Securities Rulemaking Board to engage in extensive rulemaking to regulate transactions in municipal securities. 15 U.S.C. 78o-3 (1986). Section 15C of the Exchange Act, which takes effect in July 1987, will impose registration and regulatory requirements on entities that effect transactions in government securities. 15 U.S.C. 78o-4 (1987).

D. Proposed Amendments to Section 15(a) of the Securities Exchange Act

The proposed legislation would also amend section 15(a) of the Exchange Act to require that banks establish separate entities to engage in securities activities in order to ensure that a bank's securities activities, and the Commission's regulation of those activities, do not interfere with the operation and regulation of the bank's banking activities. Absent such a requirement, a bank could theoretically register itself with the Commission as a broker-dealer. At least two significant regulatory conflicts might then arise: (1) a bank would be required to comply with the financial requirements contained in the Commission's net capital rule, which differ, in both the level of capital required to be maintained, and the permissible assets that may be included in computing capital, from those imposed by banking regulators, and (2) in the event of a liquidation of the bank, SIPC and the Federal Deposit Insurance Corporation ("FDIC") might find themselves charged with liquidating the same entity. Mandatory isolation of securities activities in a separate corporate entity that is regulated by the Commission would eliminate these conflicts. Such separation would also significantly insulate the safety and soundness of the bank from potential downturns in the securities affiliate's business. In addition, the insurance provided by SIPC to a registered broker-dealer subsidiary or affiliate would protect the Federal

bank insurance funds from claims arising from securities activities. 33/

Proposed section 15(a)(2) furthers the goals of functional regulation without imposing additional regulatory burdens on banks that are already extensively regulated from the prospective of safety and soundness. If the proposed amendments are adopted, the Commission anticipates cooperating with the banking regulators to minimize duplicative oversight and regulation of bank securities affiliates by developing procedures for the sharing of regulatory information to maximize the safety and soundness of parent financial institutions, protection of securities entities' customers, and the integrity of their activities in the securities markets.

Conclusion

The Securities and Exchange Commission believes that the proposed changes are necessary to ensure the Commission's ability to protect investors, maintain fair and equitable markets, effectively regulate those markets and their participants, and close existing gaps in regulatory authority.

33/ This proposal is consistent with the Bush Task Force's endorsement of regulation by function, rather than by outmoded industry classifications. *See* Blueprint for Reform: Report of the Task Group on Regulation of Financial Services at 12, 91 (1984).

TESTIMONY OF
L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

Good morning, Mr. Chairman and members of the Committee. We are pleased to testify today on the subject of financial services reform and on two of the bills recently introduced by members of this Committee. We would like to express our appreciation to you, Mr. Chairman and Senator Garn, as well as Senators Wirth, Graham, D'Amato and Cranston for advancing the reform process through the introduction of financial restructuring measures.

The Federal Deposit Insurance Corporation's views on overall financial services reform and the structure of the financial services industry are set forth in our study Mandate for Change: Restructuring the Banking Industry, a copy of which is being submitted today for the record. The major conclusions of that study will be described briefly at the beginning of my testimony, followed by the FDIC's views on the two bills on which we have been requested to testify. Because the bill sponsored by Senators D'Amato and Cranston was just introduced, it will not be addressed in this statement. We hope, however, that it will be considered seriously along with the other two measures.

Competitive forces and financial markets, both domestic and international, have changed dramatically since 1933 when the Glass-Steagall Act first imposed a partial separation between banking and securities activities and since 1956 when the Bank Holding Act further limited the activities of bank affiliates. These changes are addressed at length in our study.

Existing restrictions on banking activities have handicapped the banking industry in today's rapidly changing financial environment. The effect of these restrictions on banks is amply demonstrated by the appended chart that compares the annual growth rate of banks between 1980 and 1986 to that of other financial services firms. Of particular importance is a comparison of banks' growth rate of approximately eight percent during that period with that of mutual funds and securities brokers and dealers which grew at rates of approximately 33 percent and 28 percent, respectively. Clearly, banks are not being permitted to keep pace with their competitors in meeting the challenges of the changing marketplace.

The inability of banks to compete effectively with other financial firms concerns the FDIC since the situation could lead to a less safe and sound banking system. Without a doubt, banks are special. Because of deposit insurance, banks essentially borrow on the credit of the United States Government. Moreover, the banking system provides a safe harbor for the savings of consumers, reserve liquidity and the funds transfer mechanism in this country -- all of which are essential to the United States economy. Thus, any threat to the banking system is a threat to the intermediation process, private sector liquidity, the payments system and our economy.

A strong and more efficient banking system benefits consumers as well. Increased competition and economies of scale and scope result in economic efficiency which, in turn, results in lower costs to banks and bank customers. The public also benefits from increased levels of safety and soundness in our nation's banks. But, the system must prosper in order to be safe and sound and prosperity can be achieved only if banks are free to attract capital and compete effectively, at home and abroad. The FDIC believes that structural reform of our financial system is necessary to permit banks to compete and prosper.

A number of key objectives should guide any structural reform effort. Those objectives are: a viable and competitive financial system and a safe and sound banking system, increased benefits for consumers through enhanced competition, and sufficient flexibility to respond to technological change. One final goal is to find the financial restructuring alternative that is the simplest and least costly to the economic system, consistent with these other objectives. Those objectives guided the development of our study. We believe that the same objectives should guide the Committee in considering financial reform and the two bills being addressed today.

FDIC RECOMMENDATIONS FOR STRUCTURAL REFORM

From our perspective as the deposit insurer, the most important issue in restructuring the banking industry is the appropriate role of banking safety supervision in the evolving financial services sector. THE PIVOTAL QUESTION to that issue is: Can a bank be insulated from those who might misuse or abuse it? Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? If the answer is "yes," there is no reason to legislate the separation of commercial banking from securities activities and, for that matter, in the longer term from other financial and nonfinancial activities.

The conclusion of the FDIC study is that such a supervisory wall can be created and that supervising conflicts of interest is the key to an effective wall. That conclusion is based on 54 years of supervisory experience. The FDIC supervisory role has included effective supervision of the inherent conflicts that arise when bank directors also are borrowers of the bank. It also has provided effective supervision of the relationship between the parent holding company, affiliated banks and the parent's nonbank subsidiaries. Satisfactory supervision of these conflicts reinforces the conclusion that any new conflicts can be regulated appropriately to ensure the safety and soundness of the banking system.

The tools needed for insulating banks and establishing the "supervisory wall" are only a logical extension of safeguards contained in existing law to protect banks from insider abuse and conflicts of interest. Those tools are discussed in detail in our study. They include (1) the transaction limitations contained in Sections 23A and 23B of the Federal Reserve Act, (2) the exclusion of investments in nonbanking subsidiaries in determining bank regulatory-required capital, (3) the authority to audit both sides of any transaction between a bank and its affiliates or subsidiaries, (4) flexibility for bank supervisors to collect financial data from affiliated nonbanking entities, to prohibit any transactions deemed to jeopardize the safety and soundness of banks and to require that activities which pose undue risk be housed outside the bank, and (5) additional penalties for those who violate the rules.

Even with these or more stringent insulation mechanisms, abuse cannot be prevented in all cases. No matter what kind of structure is in place, abuses will occur. While most people play by the rules -- particularly if the rules are reasonable -- some will seek to avoid them. Thus, the supervisory challenge is to identify and restrain the minority who do not follow the rules. We believe that regulators can meet that challenge and, thus, ensure that the system is safe and sound. While supervisors will seek to keep every bank safe, it must be emphasized that the primary objective is to keep the system safe and sound.

Given adequate supervisory insulation of the bank, direct banking regulatory and supervisory authority over bank owners and nonbanking affiliates and subsidiaries is neither necessary nor desirable. Bank regulation and safety supervision could be focused on the bank -- and on the bank alone. There would be INCREASED REGULATION AND SUPERVISION OF BANKS -- focusing regulation where the Government has an interest -- and any required regulation of the entities affiliated with that bank would be performed along functional lines. A supervisory wall would permit the dismantling of banking laws that regulate the activities of nonbanking entities -- namely, Glass-Steagall and much of the Bank Holding Company Act -- and would leave the regulation and supervision of these nonbanking entities to the appropriate functional regulator.

An appropriately insulated banking system also permits structural flexibility. In other words, it permits nonbanking activities to be undertaken either in subsidiaries or holding company affiliates of the insulated bank.

S. 1886

I would like to begin my comments on S. 1886 by expressing our appreciation to you, Chairman Proxmire and Senator Garn, for all of your efforts towards the introduction of this measure and thank you for considering the views of the FDIC in that process. We view S. 1886 as a first step in enhancing the competitiveness of the financial services industry. We believe that ultimately all the activity restrictions contained in the Bank Holding Company Act, as well as Glass-Steagall, should be eliminated. However, we believe it is prudent not to do it all at once. A phaseout approach is appropriate. Thus, we agree that the repeal of Sections 20 and 32 of Glass-Steagall is a sound first step towards total financial reform.

We must recognize, however, that by eliminating only the Glass-Steagall restrictions, a fair competitive "two-way street" between securities firms and banks is not assured since many securities firms are affiliated with companies engaged in activities not permitted to bank affiliates. Total competitive equality between banks and securities firms can be established only if the activity restrictions and other portions of the Bank Holding Company Act also are removed from qualified securities firms. The Committee should consider adding exceptions to the Bank Holding Company Act activity restrictions for securities firms whose primary business is securities.

Our specific comments on S. 1886 will focus on (1) bank insulation, (2) functional regulation, (3) corporate structure, (4) activities permitted within the bank and (5) concentration limitations. In each case, the provisions contained in the bill have been evaluated by measuring them against the recommendations of our longer range goals for restructuring.

Bank Insulation. S. 1886 provides extensive insulation of banks from the activities of their securities affiliates. Investments in securities affiliates must be out of excess funds, over and above the amount of capital required for bank holding companies by the Federal Reserve Board. The bill prohibits virtually all bank extensions of credit to, and purchases of assets from, securities affiliates. It also expressly prohibits extensions of credit to third parties in a number of instances in which the credit extension would facilitate transactions of a securities affiliate. Subject to a small bank organization exception and specific exceptions granted by the Federal Reserve Board, all officer and director interlocks between banks and their securities affiliates are prohibited. Finally, disclosure requirements reinforce the separation between banks and their securities affiliates and ensure that customers are aware that securities transactions are not covered by federal deposit insurance.

The FDIC believes that the insulation mechanisms provided in S. 1886 strike a good balance between adequately insulating banks on the one hand, and allowing banks and their securities affiliates to benefit from natural synergies on the other. Generally, the separation mechanisms seem to be appropriate and not too burdensome. We support the concept of requiring that the capitalization of securities affiliates be out of capital in excess of regulatory-required capital, although we believe at some point the Committee should consider whether, in fact, it believes holding company capital -- as opposed to bank capital -- should be regulated at all by bank regulators. We believe the disclosure requirements mandated by the bill are significant to adequate bank insulation and vitally important to customer protection. Since we believe that a total prohibition against interlocking officers and directors may not be necessary, we are glad to see that there are exceptions to that prohibition.

While we doubt the need for a total prohibition against virtually all transactions between banks and their securities affiliates and between banks and third parties that involve the securities affiliate, it may be the conservative place to start. Sections 23A and 23B already impose stringent transaction, collateral and arm's-length requirements on transactions between banks and their affiliates. Moreover, both of those sections already apply to transactions by a bank with any third party if the proceeds of the transaction "are used for the benefit of, or transferred to, [an] affiliate." Thus, such third party transactions are subject to the quantitative limitations and collateral requirements of Section 23A and the arm's length requirements of Section 23B. Furthermore, the arm's-length requirements of Section 23B also specifically apply to any transaction with a third party "if an affiliate has a financial interest in the third party or if an affiliate is a participant in such transaction."

In view of the protections now in place, including the enhanced protections of the new Section 23B, we question the need for imposing an across the board, blanket prohibition against all transactions. Still at the outset it may be prudent to over-insulate and over-protect the bank to insure insulation from conflicts of interest.

Functional Regulation. The FDIC believes that functional regulation is critical to any repeal of Glass-Steagall and all further financial restructuring measures. We applaud the significant movement in that direction reflected in S. 1886. Functional regulation avoids the layers of regulation and duplication that result from subjecting companies to the jurisdiction of multiple agencies. In addition, functional regulation is fundamental to providing competitive equality among all securities firms, irrespective of whether they are affiliated with a bank.

For the most part, S. 1886 houses the regulation and supervision of bank securities affiliates in the appropriate functional regulator -- the Securities and Exchange Commission. For example, implementation and interpretation of the disclosure requirements imposed on securities affiliates would be solely the responsibility of the SEC. The SEC would be responsible for determining the adequacy of the financial and managerial resources of securities affiliates. In addition, securities affiliates would be subject only to capital requirements established by the SEC. In this regard, we believe there should be an explicit prohibition against the Federal Reserve Board requiring extra capital in a holding company based on its affiliation with a securities firm.

Another extremely important provision that furthers the goal of functional regulation is the exception from FRB examination, reporting and capital requirements provided to bank holding companies that are 80 percent engaged in securities activities, on a consolidated basis. We support that as a wise exception. We believe that a similar standard should be added to exempt companies that are primarily engaged in securities from the Bank Holding Company Act and, thus, provide a two-way competitive street between banks and securities firms.

Corporate Structure. S. 1886 requires that new securities activities be undertaken through holding company affiliates and prohibits them from being conducted by direct subsidiaries of banks. As described earlier and as outlined in detail in the FDIC study, if banks are adequately insulated -- and we believe the insulations contained in S. 1886 are more than adequate -- then from a safety and soundness viewpoint it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks.

If the risks and exposure are the same -- which we believe they are -- banks should be permitted to opt for the corporate structure that best suits their business plans. They should be able to elect to undertake new securities activities in direct subsidiaries, as well as in holding company affiliates. Small banks would benefit, since there are about 4500 banks that are not in holding companies. These companies should not be forced to incur the additional corporate and regulatory costs of establishing a holding company in order to affiliate with a securities firms. Moreover, by depriving banks of this corporate option, the bill infringes on the rights of the states to determine permissible activities for state-chartered banks.

Further, Mr. Chairman, we respectfully disagree with your view expressed to us in writing, that this issue should decide whether a bill repealing Glass-Steagall provisions is supportable. We support the bill despite the fact that we believe its provisions in this respect are unwise in principle and discriminatory with respect to small banks in practice.

Activities Permitted Within The Bank. S. 1886 would authorize national banks to (1) underwrite municipal revenue bonds, (2) sponsor and underwrite unit investment trusts that consist solely of securities that national banks are permitted to underwrite and (3) sell -- but not sponsor, manage or control -- mutual funds. The latter two activities, however, are permitted to national banks only if the national bank is not affiliated with a securities company. We strongly support the addition of these new activities to those permitted for national banks, but see no reason to prohibit them within the bank merely because the bank has a securities affiliate. If the risks and competitive dynamics associated with those activities are such that the activities are appropriate within the bank, that determination should not be affected by the bank's affiliation with any other company. In keeping with that position, we were very pleased to see that other securities activities already permitted to national banks are no longer required to be removed to a securities affiliate within one year of the establishment of such a company.

The FDIC believes that it would be appropriate for the Committee to assess whether other activities should be considered "banking" and thus be authorized specifically for national banks. In our opinion, certain activities such as the underwriting and sponsorship of mutual funds and the underwriting of commercial paper and securitized assets also could be included.

Concentration Limitations. S. 1886 would prohibit affiliations between banking firms with assets greater than $30 billion and securities firms with assets greater than $15 billion. We agree that the antitrust laws may not be sufficient to deal with such interindustry affiliations. In fact, we are in the process of analyzing and developing our own recommendations for addressing any such concentrations. At this time, we would have no conceptual objection to the approach taken in S. 1886. We would suggest, however, that there is a need to consider the international aspects of concentration as well.

S. 1891

We also want to thank Senators Wirth and Graham for furthering the prospects for financial reform through the introduction of a measure which reflects a different approach to financial restructuring. S. 1891 would permit banks to affiliate with all types of financial firms and we support that as an ultimate goal. In fact, we believe that with the proper insulation, banks should be permitted to affiliate with commercial enterprises as well, which S. 1891 specifically forbids.

While we concur with the goal of permitting banks to affiliate with firms engaged in all forms of financial activities, we believe that S. 1891 moves in the wrong direction in attempting to achieve that goal. S. 1891 would establish a Super Agency to regulate all companies that are engaged in any type of financial activity, thereby, embracing all financial corporations. Instead of developing the simplest and least costly structure, consistent with maintaining a safe and sound banking system, S. 1891 would establish a new megabureaucracy that would have authority not only over the banking industry, but most of financial America.

We believe that the essence of financial restructuring should be to construct a supervisory wall around banks that adequately insulates them from the activities of their nonbanking subsidiaries and affiliates. Given such a wall, regulation and supervision of those nonbanking entities along other than functional lines is unnecessary. This view of financial restructuring, as expressed in our study, generally is supported by the Barnard Committee

Report, the American Enterprise Institute study, the American Bankers Association's Chase study and the approach in the bill introduced by Senators Proxmire and Garn.

Finally, S. 1891 would establish a new transfer system corporation to be owned by large users and the Federal Reserve. We believe there is no need for another federal agency to oversee the nation's payment system. Appropriate regulation of the banking system can do the job.

MISCELLANEOUS MATTERS

Prior to concluding my testimony, a couple of additional matters should be mentioned. First, irrespective of whether the Congress has made progress on financial restructuring legislation, the FDIC opposes any extension of any part of the moratorium which is scheduled to expire on March 1, 1988. In view of the rapidly changing marketplace, we believe it would be inappropriate to continue to hinder banks' ability to respond to those changes within the limits of the law as it existed prior to the moratorium.

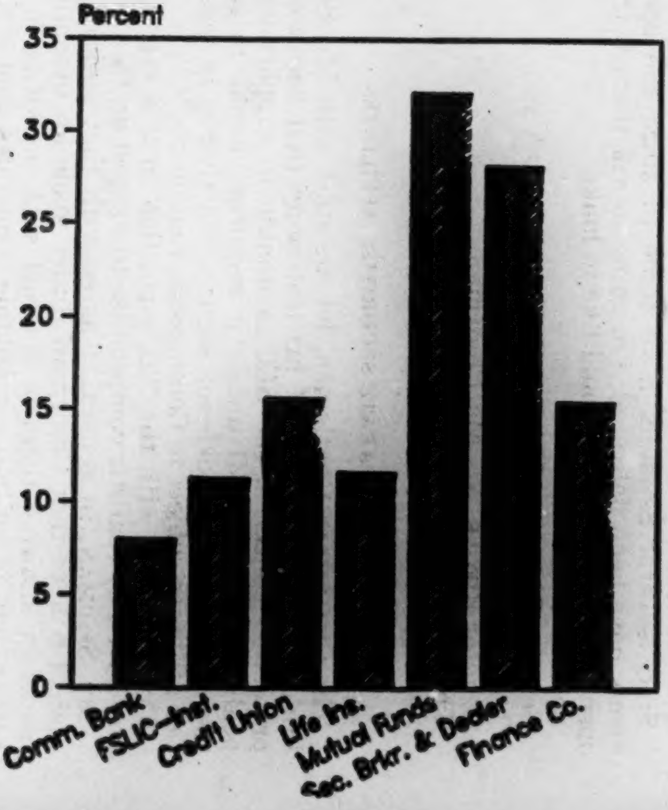
Second, the financial institution regulatory agencies recently forwarded to the Committee a proposal to amend the enforcement statutes to improve the agencies' ability to address instances of insider abuse, misconduct and fraud at our nation's depository institutions. In brief, the proposed amendments clarify some of the enforcement powers of the agencies, codify current administrative interpretations of our powers and address certain anomalies created by a recent U.S. Circuit Court of Appeals decision. For example, the amendments would (1) clarify that the agencies may require affirmative action in cease-and-desist orders to correct the conditions which resulted from unsafe or unsound banking practices, (2) specifically allow the agencies to place limitations on the activities of an individual at a bank without having to completely remove the individual from banking and (3) make certain that termination of employment by a bank-related person does not affect the agencies' authority to bring appropriate actions against that person for improper conduct. We would hope that this package of amendments that was produced by all five of the federal agencies would be incorporated into any bill reported out of this Committee.

CONCLUSION

The banking industry is experiencing and will continue to experience rapid and critical changes. The existing system is inequitable and inefficient. Long-range financial services industry restructuring should be undertaken. S. 1886 provides a first step toward that end. On balance, and with the reservations stated, we can support S. 1886 as enhancing the safety and soundness of the banking system. We believe, however, that S. 1891 moves the regulatory system in the wrong direction and, thus, we cannot support it.

We will be pleased to work with the Committee in its important deliberations on these bills.

Annual Growth Rates of Finanical Institutions
1980 - 1986



The **CHAIRMAN**. Thank you very much, Mr. Seidman.

Since several Senators have come in since the opening statements have been delivered, I'm going to ask them if they have an opening statement they would like to make.

Senator D'Amato.

Senator **D'AMATO**. No, Mr. Chairman, thank you.

The **CHAIRMAN**. Senator Riegle.

Senator **RIEGLE**. No, Mr. Chairman.

The **CHAIRMAN**. Senator Graham.

Senator **GRAHAM**. No, Mr. Chairman.

SEPARATE SECURITIES AFFILIATES

The **CHAIRMAN**. Gentlemen, let me start with Mr. Seidman. Mr. Ruder states on page 1 of his testimony that because of investor protection concerns, the SEC is unable to support legislation repealing Glass-Steagall unless it requires "banks to conduct both their new and their existing securities activities in separate securities affiliates subject to Commission regulation."

Do you agree with the SEC's position in this regard? If not, do you have any realistic compromise to suggest on that issue?

Mr. **SEIDMAN**. In general, I agree with that position, Mr. Chairman. I believe that Chairman Ruder made an exception for small banks in allowing them to conduct such activities in subsidiaries rather than in affiliates of holding companies, and if that is in fact his position—and I believe it is—then I would agree with him that these kinds of activities ought to be conducted in separate legal corporations.

I would only make one further point in that regard. He has made exception for two activities I believe. There may be one other one that we would like to discuss in that regard. But in general, we support his position.

The **CHAIRMAN**. As I understand his position—and Mr. Ruder will correct me if I'm wrong—his position is that the SEC is the one agency that's empowered and entrusted with the responsibility of protecting investors with full disclosure and so forth. They have the expertise. They have a remarkable record over the years and it should continue and be extended to all underwriting, whether it's done by a bank affiliate or whatever. Is that correct?

Mr. **RUDER**. That's correct.

The **CHAIRMAN**. Mr. Clarke, what's your reaction to that?

Mr. **CLARKE**. Mr. Chairman, as you know, there are a number of such activities that have been conducted in banks for some time. Our approach to the conduct of those activities has been to apply the same types of standards for investor protection as the SEC applies where it regulates.

That system seems to have worked fairly well during the time that it's been in operation.

I would urge that we not do anything that creates a cumbersome regulatory structure for the smaller banks. Chairman Ruder may well have come up with a way to deal with that problem if you allow existing activities or such activities as you would add in your bill to be conducted in subsidiaries of banks which would be regulated by the SEC.

The **Chairman**. Well, then, would you agree or would you disagree with Mr. Ruder's position that the SEC should have the authority to regulate the underwriting that's conducted by banks.

Mr. **Clark**. I would not agree regardless of how banks conduct these activities. I think it's very important for us to look at how that restructuring would take place because, as I say, we've been able to afford investor protection under our present system.

The **Chairman**. It would be very helpful if you three gentlemen can come up with some specific language that you could agree on to recommend to the committee for our consideration. We would appreciate that very much.

Mr. **Ruder**. We would be glad to work with the banking regulators to accomplish that, Senator.

The **Chairman**. Thank you.

GLASS-STEAGALL LOOPHOLE

Mr. Ruder, as you know, section 107 of S. 1886 removes the exemption from the Glass-Steagall Act for subsidiaries of State-chartered nonmember banks.

The provision is designed to close the State Glass-Steagall loophole opened by the FDIC's 1982 regulatory decision and to ensure that all banks conduct their securities activities within the framework that would be established by S. 1886.

My question is, does the SEC support that approach to preempt the States on this matter?

Mr. **Ruder**. The Securities and Exchange Commission has not looked at and does not have a position on the structural aspects of the various proposals. We have concentrated so far on the question of how the securities activities will be regulated. So that if the result of that repeal will allow us to regulate the securities activities, it is probably one which we would favor. But I must consult with the other commissioners if that answer includes a broader structural question.

The **Chairman**. Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

Following up on that question, I was pleased with Mr. Seidman's strong statement against preempting State laws. I would be interested in what Mr. Clarke has to say about providing in this measure for preemption of a law like Missouri's which would allow securities powers to be exercised in a subsidiary of the bank. What are your views on that?

Mr. **Clarke**. Senator, I would agree with you that those State laws should not be preempted. As I've indicated in more detail in my written statement, it seems to me that there is a satisfactory regulatory format already in place, and that is the one that's been implemented by the FDIC. States, such as Missouri, have authorized State-chartered banks to engage in a broader range of securities activities than some other States. The FDIC has taken the position that that's fine, but that if the FDIC is going to insure those institutions, the activities should be conducted in a subsidiary subject to certain prudential restrictions on the transactions that can take place between the bank and its subsidiary. That structure also can accommodate the notion of allowing the SEC to regulate those activities, as they would be regulated if they were conducted by a securities firm unaffiliated with a bank.

Senator **Bond**. In general, Mr. Seidman, you would agree that there are still advantages to a dual banking system which allows the States to innovate rather than saying the Federal Government should establish the ultimate guidelines? Is that fair?

Mr. **Seidman**. In general, I agree with that, Senator, and I believe in the case we've been discussing the FDIC did not open a loophole. What we did is provide safety and soundness regulation around an activity that was allowable under law, as the Supreme Court said, by the States. And I think that that is an appropriate way to proceed.

We, as the insurer, must ensure that those activities that are conducted in subsidiaries or affiliates do not jeopardize the insured depository base of the banks. So in this case, I don't think we opened a loophole. What we did is say that although the State has determined that that's an appropriate activity, for insured institutions there are regulations that must be followed if they want insurance.

IMPACT OF CONTINENTAL ILLINOIS ON MEASURES BEFORE COMMITTEE

Senator **Bond**. Mr. Clarke and Mr. Seidman, I gather you had a lengthy discussion over the Continental Illinois First Options situation before the House Banking Committee, and we would be interested in your views on how that might impact the measures now before us and also any thoughts that any of the three of you have on whether the measures that are now before us would have heightened or lessened the impact of the problems of October 19.

Mr. **Clarke**. I'd be glad to take a shot at that. Do you want me to go through the whole scenario, since we are responding to Chairman Proxmire's written inquiry on that subject?

Senator **Bond**. How about just a brief summary?

Mr. **Clarke**. The shorthand version is the following two comments. First the conditions which were imposed in writing at the time of our approval of the acquisition by Continental Illinois of First Options we believe were adequate to solve the problem that arose on October 19 and 20. Those limitations were in place. They were ultimately adhered to. And we took the enforcement action that we felt was appropriate against the bank.

The second point I would make is that were the activities of First Options conducted in a subsidiary under the type of transactional scheme that I outlined in my statement, sections 23(A) and 23(B) of the Federal Reserve Act would apply to transactions between the bank and that subsidiary. There would be an even more restrictive limit on the extent to which a bank could provide financial support, either through extensions of credit or investment, to a subsidiary.

Mr. **Seidman**. Senator, I would only say we operate not as the regulators but as partial owners of the bank. What was done in the subsidiary was something that could have been done in the bank. So it really is not at all affected directly by the legislation which we are now addressing.

The bank simply elected to do it in a subsidiary with the help of the Comptroller, but it was doing banking business.

Mr. **Ruder**. With regard to the Securities and Exchange Commission's concerns over the First Options question, the important point to us was that there was adequate liquidity in the securities markets. As I had understood it, First Options was borrowing not only from Continental Illinois but also from other banks within the system, and that was very positive. And ultimately, the bank holding company provided the liquidity necessary for First Options to meet its obligations and that also was a positive matter.

I do not see that the proposals for change here would have affected the result in those regards.

Senator **Bond**. Thank you, gentlemen.

The **Chairman**. Senator Dixon.

Senator **Dixon**. Thank you, Mr. Chairman.

Let me see if I can get a kind of a general view from the three of you that will help me in arriving at my decision. I'm not a sponsor of any of these bills and I have some reservations about all of them.

I am still interested in something that will expand substantially the powers of financial institutions in a variety of ways. I was a very active player in the bill that we passed in 1984, 89 to 5, on the Senate side. I think members of this committee know that I was very active in connection with H.R. 27 we recently passed, not because I thought it was a great bill, but because I thought it was a good first step to get us to a place where we could pass a good bill. And I am interested in passing a good bill by March 1 of next year and I'm certainly against any extension of the moratorium, may I say to Mr. Seidman. So I want some legislation.

I think it's interesting to see that we are discussing the repeal of Glass-Steagall and a lot of very, very innovative things here in light of the fact that Glass-Steagall and Federal deposit insurance and all those things were passed in 1933 in the depths of the depression after a stock market crash when there were more bank failures than any time in the history of the country. Here we are in 1987, with a serious problem in the stock market. It dropped 508 points on October 19, more bank failures than any time since the Great Depression.

Have we given enough thought to the unrepresented people out there in the country that aren't banks or securities firms or some of the competitors we deal with every day in this committee? Are we really thinking about safety and soundness enough?

As an example of that, I realize that we say there won't be interlocking directorships between the securities affiliate and the bank and so forth, but is that really enough? Do we really believe that out there there won't be the kinds of exchanges of intelligence and other things that are sometimes disadvantageous to the public generally? Have we given that enough thought?

Mr. **Seidman**. Who would you like to respond?

Senator **Dixon**. I'd like all of you to respond separately.

Mr. **Ruder**. In our written testimony, we have referred to some conflict problems which we feel are not adequately addressed in the proposed bills.

We think that closer attention needs to be paid at least to one of the areas that you mentioned, information exchange, so that information is not misused and that the Chinese wall concept is thoroughly adhered to. One of the reasons we suggested that the affiliate structure is preferable is that we feel that there would be a greater separation by use of an affiliate than there would be with a subsidiary, although we recognize for small banks that a subsidiary approach may be the way to go.

DEPOSIT INSURANCE PROVIDES UNFAIR ADVANTAGE

Senator **Dixon**. I might make this specifically for you, Mr. Seidman, because it would be more in your area. One of the criticisms of letting bank holding companies into the securities business is that it creates an unfair competitive advantage because of the existence of deposit insurance, the argument being that deposit insurance permits banking organizations to take more risk, secure in the knowledge that deposit insurance will provide protection if things go sour. This argument is made with particular force with respect to money center banks which are too big to let fail, let's face it, and I was very much involved with some of those things during my first term and didn't want those banks to fail. But what do you say to that sort of thing?

Mr. **Seidman**. Well, I would answer that by saying that the whole thrust of our approach is to make sure that the bank is insulated from loss if the securities affiliate or subsidiary fails. Therefore, it cannot support it through use of deposit insurance.

We are, after all, the insurers and the losers if that wall is not properly constructed and appropriately supervised. We believe, based on our experience, that it can be. With respect to the fact that no large banks fail, banks do fail. Depositors of large banks have been protected. Shareholders and managements have not been protected. There is a very substantial group of shareholders and management out there that feel the results of this type of failure in the same way they would if all uninsured depositors felt the failure.

So I think there is a market discipline out there in the stockholder and management side and that is an additional factor why we believe that the insulation can be effective.

Senator **Dixon**. Being the devil's advocate just a moment further, another major criticism I hear a lot is that letting banks into the securities business would create a real opportunity for tie-in services. What do you say to that?

Mr. **Seidman**. Well, I think that tie-in services can be met by two things. One, by competition, which in and of itself will make tie-ins difficult; and second, by regulatory rules if there are abuses in the area.

I would say that I think it's very important that securities firms be able to move in and own banks so that we have a level, competitive, two-way street. And that's one of the criticisms which we have of the bill as it's now presented by the Chairman.

Senator **Dixon**. Mr. Chairman, my time is up, but may I say to all three of the witnesses, I would value very highly any correspondence from you suggesting a variety of things that you think protect the safety and soundness features of whatever we ultimately do in this regard. I thank you.

The CHAIRMAN. Thank you, Senator Dixon.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I find it interesting that I have heard now from Treasury, from the gentlemen before us, and from others, that in terms of restructuring and dealing with literally all of the problems that S. 1905 may be the way to go, but not now.

I would suggest that that's the same argument that we've been hearing for the past 10 years. If we undertake the approach that has been advanced that would give to banks some expanded powers and basically say, "We've done our job. Glass-Steagall is no longer." I think that these people are wrong—failure to act now will not make our task easier next year.

Those who seek to make our financial institutions the competitive players in the world markets will have missed their mark, that the capital infusion that we seek into the area of financial services and into the banking system itself will not be if we don't enact S. 1905. We'll just have more players in the securities areas without increasing the size of the market. Further, we will not have brought in the kind of capital needed in the banking system. If people who think that the securities area will be the area that will bring about this great capital infusion, just take a look and see what's happening on Wall Street today for those who have had those powers and who have had the game, so to speak, with a limited number of players.

The activity in the future does not look like it's going to be increasing. So we will have more players without a larger market.

When we talk about evenhandedness, that S. 1886 certainly gives to banking institutions the opportunity to compete in areas where they have been restricted, but it is not a two-way street. S. 1886 places as it relates to those securities firms who would like to become involved in the other areas—banking, et cetera—at a disadvantage.

I don't believe that this is the approach that will bring about a resolution of the issues before one committee.

Why is it that those of us who are on this committee who will be basically making the decision, setting the standards—and I point to the chairman's overwhelming support given to him and Senator Garn on the floor in the last bill that was passed and in previous bills—take the attitude that we will fail in an effort to comprehensively restructure the institutions when I believe all of the regulators who have appeared before us, including our witnesses today and Treasury, have indicated that there is that need?

Then they raise the question, politically, is it feasible? I would suggest, Mr. Chairman, that under your leadership and that of Senator Garn's that it really is feasible, that those of us who have fought to preserve Glass-Steagall, and this Senator in particular—and I've always raised as a concern that I wanted to be assured that the depositors in our banking system would be protected and that the FDIC would not be used as a vehicle to give unfair competition or indeed to insure financial activities outside of the banking realm. I think if we can construct a firewall, it can work both ways—to protect those activities whether or not there's a securities firm that has that holding company of the bank which sets up the holding company and all of the other activities.

That's why I would really hope, Mr. Chairman and other members of the committee, that we would carefully look and attempt to undertake that comprehensive review and support legislation that would treat this totally.

I conclude by saying this, Mr. Chairman. With the pressure of the moratorium coming off by March 1, I think we have a splendid opportunity to be able to do that which we might not otherwise have and certainly I think that both the chairman and Senator Garn should be commended for having the patience last year in setting the framework whereby we have seen I think a number of strong proposals that might not otherwise ever have come about.

The status quo as it relates to all of the players in the marketplace no longer can be continued and I think people have now turned to reason and compromise. So I think we owe a great debt of gratitude to the chairman and to Senator Garn for setting the framework in which we have a very real opportunity politically to achieve that which has eluded this committee for so many years.

The **CHAIRMAN**. Thank you, Senator D'Amato.

Senator Graham.

Senator **GRAHAM**. Thank you very much, Mr. Chairman.

There is a question that I would like to ask of each of the panelists, which is to assume the role of a diagnostician and suggest what you think are the principal ailments within the particular area of the system for which you are responsible so that we, as physicians, can try and direct our attention where it can do the most good.

EXCESSIVE CONCENTRATION OF SECURITIES ACTIVITIES

Let me suggest one area that has been mentioned as an area of illness that particularly relates to Glass-Steagall, and that is the excessive concentration of securities activities within a relatively small set of firms and the assumption that that carries with it that there is not a fully competitive environment.

Would you, Mr. Ruder, identify that as being an illness in the current system; and, if so, why do we have that concentration and what effect do you believe the adoption of a relaxation of Glass-Steagall would have?

Mr. **RUDER**. The Commission does not have a position on the concentration matter and my views therefore would be my own on this.

I think that the antitrust laws would be an effective way of dealing with concentration problems. If one looks beyond the antitrust laws to ask whether there are indeed any problems of concentration, one has to ask about the industry in separate phases. One area is that of equity underwriting and in that area it is true that there are major underwriters and not so major underwriters. But that is not a signficant change historically nor one which has been of great concern to the Commission in past years. So I could not identify that as a problem. If one looks at concentration with respect to broker-dealer activities, one gets an entirely different perspective; that is, if one looks at market making, there is a great deal of competition, and in agency transactions, there also is a great deal of competition.

So in those areas, again, I don't see any structural defect with respect to concentration from my point of view, I think that with respect to the latter two areas, at least, I reflect what I understand to be Commissioners' views.

Senator **GRAHAM**. This question is to all three of you. What do you see as the principal concerns, problem areas, to which whatever reform efforts are undertaken should be primarily directed?

Mr. **CLARKE**. Senator, I'd be glad to take a shot at that.

With my diagnostician's hat on, I would identify two ailments that exist in the banking industry today. One of them is the competition that has come from so many other financial service deliverers. This in itself is not harmful; in fact, it's very beneficial to the user of those financial services. But to the extent that banks are not able to compete and offer comparable services, they are having a very difficult time retaining their markets and their customer relationships.

The second problem is in the area of diversification. I think banks have a growing need to be able to diversify their income sources and to diversify the areas of risk to which they are exposed.

Mr. **SEIDMAN**. Senator, from our point of view as an insurer, we are primarily interested in the safety and soundness of the banking system since we pay the bill when banks become unsound.

We see, under current competitive conditions, increasing risks being taken in the banking system, increasing nonperforming loans, increasing activities which expose the banks to greater risks because they are excluded from certain areas which would be their natural areas for business expansion.

So in looking at the overall situation, we are concerned that this activity makes the system less safe and sound, makes it less attractive for attracting new capital, and in the end the system must be able to attract new capital in order to maintain its safe and sound position. So I would diagnose the patient in that way.

Mr. **RUDER**. If I may respond to that, the Commission has been very worried over the past year with regard to the reaction of the banking community to competition from the securities industry, a competition which we acknowledge exists. As a result of that competition, it appears that there has been some relaxation from the banking regulators regarding the kinds of activities in which banking firms can engage, which indeed include securities activities.

It was for that reason that we passed rule 3(b)(9), which attempted to regulate bank broker-dealer activities. When that rule was declared invalid by the court, we proposed the Bank Broker-Dealer bill. We feel that, in fact, banks have been entering the securities business without being subject to our investor protection regulations.

Senator **GRAHAM**. Thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Garn.

Senator **GARN**. Thank you, Mr. Chairman. That explains my absence, and I apologize for not being here, but we have had since 10 o'clock an Appropriations Committee markup going on, both on foreign operations and defense appropriations. So we're sort of playing musical chairs, Senator Proxmire and I, to cover both committees at the same time. I think it proves what I've said for a long time, that if Congress would adjourn by the first of October, like we are supposed to, the country would be safe for at least 3 months of the year and we wouldn't get into the zoo that exists in the closing days of a session when lots of legislation comes up that should never see the light of day, and we're in that silly season. Unfortunately, I've experienced 13 of them, but that's my explanation for not being with you for the first hour.

Rather than ask you some questions, Senator D'Amato stimulated some thoughts in me when he talked about the patience of Senator Proxmire and me. Well, if he was still here—and I'll tell him personally—my patience is growing very, very thin with this entire process.

As I sit here, I see some different regulators out here than I've seen at various times, but for 13 years Chairman Proxmire and I have accumulated more than 20,000 pages of testimony on these issues, and there still has only been one or two significant pieces of legislation passed in that period of time. It's absurd. It's ridiculous that we can see a marketplace change as dramatically as it has—forget 13 years—just look at the last 5 or look at the last 2. Congress still doesn't have the ability to address these issues, while the States and the courts do. Administrations and regulators come and go, and the lobbyists are basically the same. There are a few changes of faces, but I recognize most all of them.

I think it's a disgrace. This Senator's patience is getting very, very thin. I'm to the point where I don't care what is done as long we do something.

I mentioned yesterday I was a year old when Glass-Steagall was passed. I've changed considerably, particularly my hairline—no, when I was a year old it was about the same. [Laughter.]

But here we sit. I don't know. I almost get to the point where I say why try anymore? The reason why we have no progress is because nobody really wants to give up his own self-interest. We've got the SIA, the securities industry, the most concentrated industry in this country—you have the statistics represented in yesterday's testimony—it's appalling, the top four or five firms, what they control in this country. And we hear about safety and soundness of banks; you can't let them in our business because of safety and soundness. Well, it's all right for the securities business to be in the banking business. That's all right. Don't worry about what you do to safety and soundness as you rip off a few billion dollars here or there.

And you've got the ABA who can't get their act together because you've got the independent bankers, the reserve city bankers, all the different parts, and they argue and fight and do the SIA's work for them. Basically, SIA doesn't have to do very much, while the bankers cut themselves up.

Then you've got the insurance agents who don't care about the whole thing as long as you protect their little bailiwick. They want State control, keep that law for them, no Federal regulation for insurance agents, but come back here and prevent all the banks from getting in the insurance business.

You throw in the realtors and you go through all the other groups. Frankly, ladies and gentlemen, I'm getting sick of all of you, just really sick of all of you, and the whole game and the disgrace, and you ought to all be ashamed, along with the Congress, that 13 years have gone by since I've been here and the testimony is basically the same. The problem grows and we don't do anything because everybody is looking out for their own bailiwick and as long as they get their piece of the bill, it's fine. But if they don't, kill the whole thing.

That's why neither Chairman Proxmire and I have been successful over the years except only in a very, very moderate way. If people really want to go ahead with the 50 States making decisions and the courts and the loophole lawyers, while all the foreigners rip off our business and the international capital markets grow and the Japanese take over with their Tokyo Stock Exchange and their securities firms operating here, all the Japanese banks becoming bigger and London becoming the center of the economic world—be my guest, while you worry about the dying savings and loan across the street or your securities competitor.

I mean it's just absolutely unbelievable to me. So if the Senator were still here, he would find out this Senator's patience is diminishing very rapidly, if there is any left whatsoever.

Thank you, Senator Graham. I'm going back to the Appropriations Committee where I might be able to do something useful.

Senator **Graham**. Thank you, Senator Garn.

To pick up on that last note of frustration, my experience in 21 years of public life has been that when you're dealing with entrenched economic interests that the status quo has an enormous leverage and that change tends to only occur when the users of the system—those people who are affected by the ills that you have just described—see that they have a significant stake that is worth becoming involved on the part of change.

The ills that you have diagnosed tend to be internal ills—that commercial banks are facing competition from nonregulated entities, the need for banks to be able to diversify, increasing risks taken by banks as a result of their being constricted to traditional areas while those traditional areas are facing new competition.

COMPLAINTS AND REFORM

All those I think are true, but the question is, who cares, other than the banks themselves? And why is it that, if these negative impacts are being felt by the users of the system, that the users are not coming to this panel at least asking for reform? I would be curious—one, have they been coming to you asking for reform; and, if so, what have they been asking for and what have been their list of complaints?

Mr. **Clarke**. Senator, there really are two users that we should focus on. There are the institutions themselves which are subjected to these problems that we diagnosed, and there are the users of those institutions, the consumers.

Part of the problem in getting any very effective response from consumers is that the consumer can go to other places and obtain the services. That is what troubles me as a bank supervisor looking toward the long-term health of the banking business. If we keep the banks bottled up to the point that they cannot compete for that business and offer those products to the consumers who are going elsewhere, we're going to wake up 10 years from now and find a very, very weakened banking system.

This is not a jazzy political issue. This is much more of a public policy issue where I think the Congress is going to have to exert some leadership apart from what you may be hearing or not hearing from the end user.

Mr. **SEIDMAN**. Could I comment on that, Senator?

Senator **GRAHAM**. Yes.

Mr. **SEIDMAN**. I think this is the kind of issue that when the consumers become concerned—and they will when they begin to feel that their deposit insurance is no longer valid and when they begin to believe that the banking system no longer is sound in this country, then we will hear from the consumers and it will be too late.

What we are trying to do is deal with the fact that banks are special in our economic system. They are the safe harbor for the small investor. They are the mechanism through which transfers in the economic system take place. And, as a matter of fact, they are using the credit of the United States in their operations.

Any threat to any one of these functions will bring the consumers on because those functions are essential to our economic system. But by the time that we achieve consumer real interest, it will, unfortunately, be very late in the game.

Senator **GRAHAM**. The severity of the problem, as you have just described it, places before us the question of whether our response should be a limited one, such as dealing with the specific issue of Glass-Steagall, or whether we should take advantage of what appears to be a positive public awareness and political situation to strike for more fundamental change which might well include Glass-Steagall reform that would have as its objective a strengthened, renewed, revitalized banking system that could avoid those ills.

Is your advocacy of the approach recommended by the Chairman and Senator Garn essentially one of what you think is possible or what you think is desirable in terms of dealing with these ills?

Mr. **CLARKE**. Senator, from my standpoint, to some extent, it's really a matter of time sequence. I have said for a long time that I believe that, if properly insulated and regulated, there are few activities that commercial banks couldn't safely affiliate with. But at the time these hearings were scheduled, we were called upon to comment on a bill that was dealing with substantial reform of the Glass-Steagall Act. I think that a broadly-based consensus is developing that that's something that needs to be done. The three bills that are pending before this committee all acknowledge that's something that needs to be done.

You are the political experts. If you believe that it is doable, I would be more than enthusiastic about a broader opportunity for structural reform. But my purpose in coming before the committee has been to outline the problem and to urge strongly that the Congress do something about it. If all that can be done at this particular time is allow banks to compete in the securities area, then I am for substantial Glass-Steagall reform. If you think it's possible to get some other things done at the same time, then I'm for that, too, because both options improve competitive opportunities for banks and improve the opportunity for them to diversify both their risks and their earning sources.

Mr. SEIDMAN. Senator, I would call your attention, of course, to our work in this field which does call for total restructuring, and if it is at all feasible, we would certainly support it. Whether or not it's feasible, I certainly am not an expert.

I would call attention to the way tax reform finally was enacted. They finally said, "We won't piecemeal it. We'll take it all on." And, as I analyzed it, the fundamental support for that was what Senator Garn has just said, we're tired of looking at all the special interests; we're going to do something on an overall basis.

If that atmosphere could be created for bank restructuring, I think it would be possible to do more and we would certainly support it.

Mr. RUDER. If I might comment, Senator, I think if one is looking at this structurally, you really have two problems. One is the problem of competition in the very largest sense, including global competition—the question of whether our securities markets and our capital markets are going to be structured so that the United States will be able to compete internationally with the growing climate of capital transfers and securities activities overseas.

The other problem involves the interests of the small banks and the small securities companies throughout the country. Their concerns are not nearly so much whether and how we can enter into foreign competition and compete globally. They have much different competitive concerns.

So when you begin to look at these questions structurally, you may be dealing with two different environments and your problem, as I see it, is how to structure Glass-Steagall reform in order to meet the problems from the problems posed by both environments.

One of the reasons that we have come before you with our concerns about bank activities in the securities industry has been our recognition of both environments.

On the global level, we recognize—at least I speaking personally—a need for our securities industry to be able to be competitive abroad. On the more local level, as administrators in the securities area, we have had a long, long history of seeing that people when they deal with people are going to be greedy and are going to engage in minor frauds or perhaps major frauds. Thus, we believe it's very important to have the Securities and Exchange Commission involved as a policeman, to be out there watching for activities that will impact negatively on the investor.

So that our reason for wanting to be active in the way in which this bill is structured is to preserve what we consider to be an important aspect of our laws; that is, to provide protections for investors.

We do understand the problem of trying to create that result at the same time that you're trying to bring about structural reform that will allow our securities industry and our banking industry to be more competitive.

Senator GRAHAM. Mr. Chairman, if I could ask one last question, I would have completed my list.

PRESENT AND FUTURE NEEDS

I'd like now to ask you to move from your physician role to that of an architect and ask the question: What kind of house do we want to construct with particular attention to three potential families that might want to occupy the building after we are through, and how will they be served. How will State and local governments, which are major users of the securities industry in order to finance their infrastructure; second, the housing industry which has had a particular interest in the availability of long-term financing for its customers; and third, the traditional user of the banking system who deposits funds, makes small loans and uses it as a safe harbor for their savings.

From the perspective of those three users of the system, what kind of house should we try to have available for them to occupy 5 or 10 years from now?

Mr. CLARKE. I'm not sure that I quite follow the analogy of building a house. Are you talking about a regulatory structure, or are you talking about the products that might be offered to each of those three consumers?

Senator GRAHAM. Well, I see the regulatory structure is like the steel girders that provide the structural system for our residence and the products are the heating and air conditioning system that make it habitable. Those may not be the best analogies, just the best I can do at this moment.

What I'm trying to do is to cause us to think not in constricted terms of where the status quo has happened to have brought us, but rather where we would like to go, where we think would be the most desirable destination would be, particularly with a focus on the consumers, the users of the system, and my three examples tried to illustrate the diversity of people who have a significant stake in how this restructuring will finally evolve.

Mr. CLARKE. I would like to see State and local governments be able to utilize banks for more of their financing. They have been extensive users of bank underwriting to the extent that they have been permitted to be. If banks are able to underwrite municipal revenue bonds, the increased competition could reduce borrowing costs for State and local governments.

The housing industry, of course, already has access to financing, both through commercial banks and their affiliates. Bank authority to underwrite mortgage-backed securities, however, could reduce underwriting fees. That increase in competition would benefit the housing industry.

Finally, the traditional user of the banking system includes a variety of parties, ranging from the individual checking or credit card account holder to major corporations, which still, although to a limited extent, use the banking industry for their financing. Those users would benefit from access through their banks, which have been the traditional delivery system for financial services in this country, to the same financial services that they can get from other competitors. The increased competition from banks could lead to more innovative products and lower costs.

The three users that you listed will, in my judgment, all benefit from a more competitive banking system, which I think will come about through the restructuring that we've been talking about.

Mr. **SEIDMAN**. I would say, Senator, that all of the entities you have referred to are customers and customers are benefited by multiple sources of competitive services. The only guidelines that we need beyond that are to make sure the consumer is properly informed about the service he's getting, which the SEC can do, and that the entities themselves are functioning in a way that they will not jeopardize the service by becoming unsafe and unsound in the banking system.

So again, I would say that we need to make sure that the government does its job, which is to keep banking safe and sound and keep the consumer informed, and then let the competitive system provide him with the best services.

Mr. **RUDER**. If I could respond briefly, I think there is a significant difference to be drawn between underwriting activities for general obligation bonds and revenue bonds and equities.

Traditionally, the equity underwriting has not been permissable in the bank area, so that is the area in which banks have the least experience. So that would be the area in which the Securities and Exchange Commission would have the greatest concern.

In the municipal revenue bond and the general obligation bond areas, we have not asserted a right or a need to have the kind of full registration disclosures which we think are necessary in the equity area and in the corporate bond area.

Nevertheless, there are problems in dealing in the revenue bond area and the general obligation bond area. Thus far, we have been satisfied that allowing the underwriting of general obligation bonds in banks has not created disclosure or dealing problems. However, we have some concerns about revenue bonds. We think it's necessary to have a structure which permits these activities to be carried on with the regulation which we think in the disclosure and sales practices area would be important.

At the small saver level, we are worried about investors, and in particular the disclosure necessary to the investors' purchasing securities. We're worried about conflicts which may result if the securities which are offered to those investors by bank affiliates are indeed securities that come from a bank, if that should be the way in which the transactions are structured.

We think that the protection here for investors comes from disclosures and from a prohibition against conflicts of interest.

Senator **GRAHAM**. Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you, Senator Graham.

Mr. Seidman, I'd like to ask you about the concentration provision in S. 1886. As you know, S. 1886 would prohibit affiliations between banking firms with assets greater than $30 billion and securities firms with assets greater than $15 billion.

The purpose of this provision would be to encourage large banks and securities firms to enter each other's businesses from scratch or by buying smaller firms and building them up.

You say on page 11 of your testimony you would have no conceptual objection to that approach, but suggest, "There's a need to consider the international aspects of concentration as well."

Now it's not clear to me what that last phrase means—"international aspects of concentration." Can you explain that and give us whatever recommendations you think we need to incorporate into S. 1886 to take account of international aspects of concentration?

Mr. SEIDMAN. Mr. Chairman, what I had in mind was that under the provisions of the bill, Merrill Lynch would not be able to buy Citibank but it would appear that the largest Japanese securities firm could buy Citibank. I think that we need to look at the world marketplace if we are going to prevent concentration and apply some kind of rules which do not put our own institutions at a disadvantage with those that are operating in the world marketplace.

Exactly how that should be done, we are working on, and we will have some suggestions for you. But in general, I think it would have to take the same form of prohibition against very large institutions from abroad buying institutions which our own institutions couldn't buy.

The CHAIRMAN. Well, that's a fascinating and dramatic example. It certainly wakes me up. Imagine a Japanese securities firm buying Citibank. I suppose that's not impossible.

Mr. SEIDMAN. It is not.

The CHAIRMAN. But that's a real nightmare.

Mr. RUDER. Senator, we have one Japanese securities firm which has just incredible capital.

The CHAIRMAN. I realize it. I realize they could do it. That's right. That's why it's a very good, appropriate warning.

Well, now, would you suggest language or what we might do about that, what we might consider?

So anything you could suggest would be very helpful because I think you're correct to be concerned.

Mr. Clarke, it's been argued that S. 1886 as presently drafted does not achieve competitive equity; it allows bank holding companies to get into the securities business but a securities firm cannot become a bank holding company unless it gives up its insurance, its real estate, and other activities not permitted bank holding companies.

However, as you point out in your testimony, there are also some inequities under current law. Bank holding companies cannot offer many securities products, but securities firms can offer the functional equivalent of most banking products, such as cash management accounts, mutual fund accounts with check-writing privileges, and so forth.

WOULD S. 1886 PROVIDE MORE OR LESS COMPETITIVE EQUITY?

In your opinion, taking all that into consideration, would S. 1886 provide more competitive equity or less competitive equity compared to current law?

Mr. CLARKE. Mr. Chairman, I believe that S. 1886 provides more competitive equity than exists under current law, but you have raised a very important point. Because of the relatively unrestricted nature of that business, securities firms have been able to engage in a variety of other activities, some of which are rather incidental to their basic business and others of which can be quite significant. It seems to me that you should consider crafting some kind of a de minimus exception—I don't know how you would define de minimus—allowing a securities firm that happens to be engaged in some other activities not currently permitted under the Bank Holding Company Act to continue to engage in those activities, as long as they don't reach a certain level, and still acquire a commercial bank.

The CHAIRMAN. That sounds like a practical appplication because we do have that problem. At the same time, if we open it up, you don't have to be very politically sensitive to recognize it would kill the bill.

I think if we open it up, as some of our colleagues have suggested, in a way that's going to try to put banking into insurance and into real estate and so forth, we're just taking on a real political juggernaut. There are so many insurance agents, so many real estate people and so forth who would fight like tigers, and you could forget about succeeding with legislation this next year or the year after or in the foreseeable future.

So I think what you suggest, a de minimus approach, might be a very practical way to try to handle it.

Chairman Ruder, in your testimony you suggest that the underwriting of municipal revenue bonds should take place in the securities affiliate rather than the bank itself.

What evidence is there that municipal revenue bonds are more risky for an issuer than municipal general obligation bonds which, as you know, the bank can underwrite now?

Mr. RUDER. I'm sorry—more risky for the issuer?

The CHAIRMAN. For an issuer, that's right.

Mr. RUDER. The Commission's concern regarding municipal revenue bonds has not focused on the issuer but on the purchaser of those municipal revenue bonds. The purchaser of a municipal revenue bond is buying a more risky bond than he is when he buys a general obligation bond.

The CHAIRMAN. Why is it more risky? As I understand general revenue bonds, one of the enormous advantages they have is that you can measure the stream of revenue in the number of times the interest is covered and that, of course, is disclosed and known and established and affirmed. So it would seem to me that that would be less risky than—after all, municipalities at times have become at least temporarily insolvent.

Mr. RUDER. At least to my knowledge, the reason that a general obligation bond is a better investment is because the taxing power of the municipality stands behind that bond, whereas in a municipal revenue bond offering it's the economic activity, not the municipality's full faith and credit, that stands behind the bond.

There have been some very unusual but dramatic circumstances in which municipal revenue bondholders have not been paid. The most dramatic one was the WPPSS controversy in Washington State in which revenues were not sufficient to repay bondholders. Another occurred in Chicago is the Calumet Skyway, which also did not produce the necessary revenues.

The CHAIRMAN. Wasn't there also a de facto default on the New York City general obligation bonds?

Mr. RUDER. There was. That's right.

The CHAIRMAN. So that happens, too.

Mr. Ruder. It does happen, but in terms of analyzing the kind of activities that are involved, we think that there is some difference. We are not, by the way, asking that general obligation bonds be placed in affiliates if the bank does not undertake municipal revenue activity, but if the municipal revenue underwriting should be undertaken, by banks, then it should go into an affiliate in circumstances in which this additional risk factor would be something that we could look at in terms of disclosure. It is the kind of disclosure that we need to regulate.

The Chairman. It's the disclosure that you're concerned about rather than the structure necessarily.

Mr. Ruder. It's the disclosure. We, indeed, have not advocated that there be a registration kind of disclosure. The kind of disclosure we think is useful is the kind of disclosure which can be forthcoming through the broker-dealer dealing activities. In such activities, the underwriter can be required to have certain information before entering into the underwriting and in selling the bonds must provide to the main purchasers of the municipal revenue bonds the kind of information that that purchaser should have.

The Chairman. Is there a potential conflict of interest introduced if the general obligation bonds are underwritten by the bank while the revenue bonds are underwritten in a securities affiliate?

Mr. Ruder. Well, we would take the position that if the bank is engaged in both activities then the general obligation bonds should also be underwritten in the securities affiliate, so as to avoid that possibility.

The Chairman. I understand you take that position, but is it partly because there's a potential conflict of interest or is it that——

Mr. Ruder. No. It has to do primarily with regulatory efficiency as we see it. That is, if the affiliate is geared up to comply with the regulations that are imposed and are beneficial in the municipal revenue bond area, which would not include registration of the bonds themselves, then we think that the general obligation bond should also be in that affiliate and subject to similar underwriting broker-dealer regulation.

The Chairman. Mr. Clarke, as you know, some representatives of community banks have voiced concerns over the provisions of S. 1886 because they fear that permitting banks and securities firms to affiliate will further erode the competitive position of community banks in their own local markets.

I note on page 8 of your testimony that you believe that "permitting the affiliation of banks and securities firms, not preventing it, is the best cure for that problem."

Can you explain why you believe that S. 1886 will enhance the competitive position of community banks?

Mr. Clarke. Mr. Chairman, as I indicated further on in the written statement, there was a very graphic demonstration of the fact that securities firms are already competing in the banks' markets in a recent Wall Street Journal article. In that article, a representative of a major investment banking firm was quoted as saying that he spends the bulk of his time traveling around small towns selling various securities products that investment banking firms can offer and banks can't. That has the result of siphoning off money that would otherwise be invested in products that the community bank is offering. If that continues over a long period of time, the relationship between the customer and the investment bank is going to become closer and closer, and it's going to become more and more difficult for the community bank to retain its customer base.

The CHAIRMAN. Thank you.

Mr. Seidman, in your written statement you say that by imposing limits on what securities can be underwritten by subsidiaries of State-chartered banks, S. 1886 "infringes on the rights of the States to determine permissible activities for State-chartered banks."

Yet section 21 of the Glass-Steagall Act has always limited the securities activities of State-chartered banks and only in recent years did your agency come up with a theory that section 21 did not apply to subsidiaries of banks.

What's your response to that?

Mr. SEIDMAN. Well, I guess our response would be that the Supreme Court examined the matter and felt that they were allowed to do what we said they were allowed to do.

The CHAIRMAN. Nevertheless, the law for some 50 years took a contrary position, right?

Mr. SEIDMAN. There were some who thought the law was contrary until it got to the Supreme Court where it was decided; yes, sir.

The CHAIRMAN. That took a long time. At any rate, your view is that the Supreme Court has spoken and that's it.

Mr. SEIDMAN. Well, they have spoken under current law. Obviously, the Congress could change that.

The CHAIRMAN. Mr. Ruder, this is a little complicated, but it's a fascinating problem to me and maybe you can help me with it.

I've heard that a nonbank holding company can double-leverage on an equity investment in a securities affiliate. What I mean by double-leverage is that the holding company would issue debt and then downstream it to the securities affiliate as an equity investment. Ultimately then, there would be no capital backing the securities affiliate's capital.

The first question is, is this true, and can a securities firm embedded in a holding company structure engage in double-leveraging?

Mr. RUDER. I'm sorry. You'll have to repeat the question one more time so that I can make sure that I understand it.

The CHAIRMAN. All right.

Mr. RUDER. And if I need some help I'll get it from the back row.

The CHAIRMAN. All right. I've heard that a nonbank holding company can double-leverage an equity investment in a securities affiliate. What I mean is that the holding company would issue debt and then downstream it to the securities affiliate as an equity investment. Ultimately then, there would be no capital backing the securities affiliate's capital.

I want to know if that's true and, if so, can a securities firm embedded in a holding company structure engage in double-leveraging?

Mr. RUDER. What you're talking about is a securities subsidiary of a commercial company, where the nonbank holding company creates a debt and drops it down into the affiliate and the affiliate gets credit for it. If the debt is in a securities affiliate, then it is a net capital rule question. We'll have to look at the net capital rules of the securities affiliate to find out whether or not that debt can be counted as part of the net capital of the securities affiliate. As I understand it, it has to be subordinated in order to be counted as capital.

The CHAIRMAN. Let me check with the row right in back of you to determine whether they think their boss is right in this case.

Mr. RUDER. I would be glad to have Mr. Ketchum give us the complicated answer to that complicated question.

The CHAIRMAN. Mr. Ketchum.

Mr. KETCHUM. Senator Proxmire, you may be asking a question regarding the accounting treatment of subordinated debt, a question which we would not claim to be experts on. However, regarding the treatment of net capital of the broker-dealer: yes, debt can be downstreamed from the affiliate and treated as good net capital for the broker-dealer, but only if it is subordinated debt and that debt is restricted so that it may not be removed within a year of contribution to the broker-dealer, and even then only with the approval of the relevant self-regulatory organization, usually either the New York Stock Exchange or the NASD.

Mr. SEIDMAN. Mr. Chairman, could I comment on that?

The CHAIRMAN. Yes, indeed.

Mr. SEIDMAN. I don't want to comment on the securities firm, but exactly that can be done with banks and is done all the time. Therefore, you get a double-leveraging where the holding company actually has debt far in excess of its capital.

That is one of the reasons that we have been saying that holding companies are sometimes a source of strength, but sometimes they can be a source of weakness instead——

The CHAIRMAN. But doesn't the bank holding company have to meet a capital requirement?

Mr. SEIDMAN. Well, it has a 6-percent consolidated capital requirement, but for most institutions which are not banks you don't find 6-percent capital being satisfactory. In fact, we know as insurers that it is not satisfactory.

The CHAIRMAN. In view of the fact that you know as an insurer—and you're the preeminent insurer in the country—shouldn't this committee consider measures that would restrict this practice on two grounds: first, safety and soundness; and second, elimination of an unfair competitive advantage of a securities holding company over a bank holding company with a securities affiliate?

Mr. SEIDMAN. I think that the committee ought to focus both in the securities case and in the bank case on the unit which is being regulated, which is the bank in one case and the broker-dealer in the other. And as far as who owns them and what they're doing, let the marketplace operate.

Our job as regulators is to see that the bank, or I believe, that the securities firm, is following the rules and is not jeopardizing its position. The holding company or whoever owns it can go along without such supervision, but our job is to see that they don't jeopardize the banks.

The **Chairman**. Well, is there or is there not a safety and soundness problem involved in this?

Mr. **Seidman**. There is a safety and soundness problem involved if we allow the bank to upstream funds to its owner and the safety and soundness of the bank would be jeopardized.

The **Chairman**. Of course, you don't regulate the securities firm. I don't know the extent to which the SEC can step in. At any rate, isn't there a safety and soundness problem in this double-leverage as far as the securities firms are concerned, aside and apart from the bank?

Mr. **Ruder**. The regulation which we would place on the securities firm would have to do with its net capital and as long as the securities firm was in net capital compliance, then we would be satisfied. If the debt which was dropped into the securities firm was used by the securities firm as part of its net capital, then we would be able to regulate it as to withdrawal. The term safety and soundness is not a securities regulation term, but if you used the term net capital, we do have adequate supervisory powers in the regulation of this securities area.

Indeed, one of the reasons that we think that the affiliate structure would work is that we would be able to regulate the net capital of the securities industry affiliate in a way which would satisfy us, no matter what the bank holding or nonbank holding company does.

The **Chairman**. Mr. Clarke, did you want to comment?

Mr. **Clarke**. Mr. Chairman, I just wanted to follow up on a point that Chairman Seidman was making. It seems to me the issue is how far you want to go in regulating the financial capacity of the shareholder. To take this one step further, envision a bank which is owned by all of us in this room. As individual shareholders, each one of us could be hocked up to our eyeballs, but there is no regulatory mechanism that looks into that. We could have all gone out and borrowed substantial amounts of money which we then invested in the bank.

In the case of double-leveraging all you've done is put a holding company in place and said isn't it terrible that the holding company can go out and borrow a lot of money and invest the money in the bank. It's really a question of whether to require some kind of financial support capacity of the shareholder in these various institutions or whether to simply regulate the capital adequacy of those institutions according to whatever terms are in force. The SEC has one set of requirements under the net capital rules. We have a different set of requirements for banks. The question is how far you want to go beyond that.

The **Chairman**. Let me ask just one more question. Mr. Seidman, on page 6 of his testimony, says that the FDIC supports S. 1886 as a first step in enhancing the competitiveness of the financial services industry. He makes it clear that the FDIC ultimately would like to go further but says:

> We believe it is prudent not to do it all at once. A phase-out approach is appropriate. Thus, we agree that the repeal of Sections 20 and 32 of Glass-Steagall is a sound first step toward total financial reform.

Mr. Gould, of Treasury, made a similar point in his testimony yesterday and I believe that the Chairman of the Federal Reserve Board, Mr. Greenspan, also takes the same position.

Do you agree with them that an incremental approach to financial reform is prudent and that S. 1886 is the right first step?

Mr. CLARKE. Mr. Chairman, we had a discussion about some of this while Senator Graham was presiding, and I commented then that you invited us to talk at this particular hearing about S. 1886 and how we felt about it. I support that legislation. The proposals that I've offered this morning represent ways I think it could be improved and what I would do differently if I were doing it all by myself, but I do approve of the overall concept in S. 1886 and compliment you for advancing it.

The CHAIRMAN. I think I should ask you to stop right there. So far, that's the best statement I've heard in a long time. [Laughter.]

Mr. CLARKE. I've said on other occasions that I think you can go further in improving the competitive opportunities for banks, but as the political experts, you have to decide whether that can be done. Personally, from a safety and soundness standpoint, I do not have any problem with going further because I think the same insulation mechanisms that you're proposing for securities activities can be employed in other areas. But the judgment that you are making, as I understand it, is that this is the approach you want to take, and I support it.

The CHAIRMAN. Thank you very much. Thank you, gentlemen, for excellent testimony. We very much appreciate it.

The committee will stand adjourned until 10 o'clock Tuesday morning.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

LEGISLATIVE PROPOSALS TO RESTRUCTURE OUR FINANCIAL SYSTEM

TUESDAY, DECEMBER 8, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Sarbanes, Dixon, Sasser, Sanford, Graham, Wirth, Garn, D'Amato, Hecht, and Chafee.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order. This morning we continue our hearings on legislation to modernize our financial structure. Before the committee today we have a panel of representatives from both the securities and the banking industries.

Welcome gentlemen, I thank each of you for meeting with us to consider these matters which are so important to the prosperity of the Nation.

Guiding the evolution of our financial structure is a delicate challenge. Congress has a responsibility to create laws that are in step with innovations in market practices with an eye toward promoting competition.

At the same time we must be respectful of the need to maintain public confidence in our financial system. If public confidence in our financial system plummets, the effect on our citizens spreads beyond the financial services sector. Corporations, homeowners, consumer and the Government all pay dearly when the credit allocation process falters.

When we update our laws we change market practices. And change ignites concern that challenge the public's confidence in our financial system. The difficult tradeoff we face as legislators is one of modulating the rate of change of our financial structure so that we may both maintain confidence and enjoy the benefits of innovation and competition. That is particularly difficult at times when the pace of market innovation has so powerfully outstripped the pace of legislative advance. With such a backlog it is tempting to try to correct all of the problems at once.

The question before us today is whether or not to repeal the Glass-Steagall Act and, perhaps to even go further by permitting holding companies containing a bank to include a broader array of activities such as insurance and real estate.

I myself believe that Glass-Steagall is a hindrance to economic efficiency. It serves as an entry barrier keeping banks, who have all of the requisite skills, from competing in what has historically been a very very profitable business.

I feel that the risks associated with permitting securities affiliates of banks to underwrite securities are manageable. It is the logical first step to take in modernizing our financial structure. Securities activities, rather than real estate, insurance, or commercial activities, are the ones which are most closely related to banking. Both securities activities and banking are elements of the same process, financial intermediation. And because of new technology, the distinctions between underwriting and lending are rapidly eroding.

I also feel strongly that we should not go further at this time. My reasons for this belief are not entirely grounded in what some have called, "political feasibility". They are based on the belief that the transition to the system of the 1990's must be undertaken gradually to permit financial services firms, consumers, and regulators to adjust to the new financial landscape and to permit public confidence to be maintained throughout the transition.

I also believe that a much greater burden of proof rests upon the shoulders of those who would also eliminate the barrier between banking and other financial activities such as insurance and real estate. The proponent have not sufficiently established that these activities can be safely undertaken by an organization which contains a bank. And they have not established that there would be concomitant social benefits.

A still greater burden of proof is incumbent upon those who would bring down the separation between banking and commercial and industrial activities. These activities are not even closely related to banking and their are no obvious synergistic benefits associated with there being combined with banking. Furthermore, there is no paucity of competition in these nonfinancial activities, so bank entry would not be likely to provide the competitive benefits that are likely to result from entry into the highly concentrated securities activities.

Nothing that we might do on Glass-Steagall prevents further restructuring at some later date if the case can be made. In my view, the case for repealing Glass-Steagall now is persuasive. The case for going further at this time is far less compelling.

Due to the shortness of time I have statements of Senators Dixon, Sasser, Sanford, D'Amato, and Chafee, and without objection, to insert in the record at this point.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Banking Committee continues its hearings on the major reform proposals introduced by a number of members of this committee. We have an expert group of witnesses before us this morning, and I look forward to their testimony.

I would simply like to take this opportunity to repeat what I said last week: I am a supporter of reform; I believe it is long overdue. However, given the history of legislative failure in this area, I think it is vitally important that we are completely realistic about what is possible to achieve in this Congress.

The Senate has passed legislation three times expanding bank asset powers. Each time the House has killed it. I believe things may be different this time if we do not give the House more on its plate than it can possibly digest.

There is a limited amount of time in which to act. It may not be possible, therefore, to be as ambitious as some would prefer. If enactment of comprehensive legislation is something of a long odds bet in this Congress, however, it does seem to me that the chances are much better that legislation addressing at least some of the issues can pass through the legislative maze.

While I do not rule out omnibus legislation, it has not worked in this committee in the past. That is why we went to a step-by-step approach to banking legislation earlier this year. I think that is a sensible course, in that it maximizes the chances for House action.

I look forward to working with my colleagues toward a markup of a solid banking bill before the moratorium expires—permanently—next March.

STATEMENT OF SENATOR JIM SASSER

Senator **SASSER**. Mr. Chairman, I see that after several days of hearings we finally have assembled here before us the major protagonists and antagonists on this issue. However, I believe that a review of the testimony will indicate that both sides have common goals: Greater and more affordable service for consumers, and a more productive and efficient, as well as, safe and sound, financial system. These are certainly worthwhile, indeed vital, objectives.

But both sides, as usual, have different approaches. And the different approaches raise serious questions about risk, conflicts of interest and concentration on the one hand, and competition, efficiency and cost, on the other.

We have to find the common ground—if there is one. Although I recognize that there are compelling arguments for each of the legislative proposals before us, I can not vote for any bill unless I am certain that the safety and soundness of the financial system will be enhanced after its enactment. Thank you.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator **SANFORD**. Mr. Chairman, I'd like to welcome today's panel of witnesses and comment that I am extremely pleased by the diversity of views and perspectives presented today and, indeed, those I expect we will hear the rest of this week. Also, Mr. Chairman, I join my colleagues in commending you for holding these hearings and providing committee members with the opportunity to explore fully the ramifications of the reforms to the banking system that this committee is considering.

I extend a special welcome to Ed Crutchfield, chairman and chief executive officer of the First Union Bank, one of the largest banks in North Carolina and the 21st largest bank nationwide. Mr.

Crutchfield has been with First Union for over 20 years. He established the bank's municipal bond department and went on in 1973 to become the bank's president at age 32. He has since moved up to become the chairman and chief executive officer of First Union Corp. Mr. Crutchfield provides us with the perspective of a regional banker representing both fairly large and smaller scale clients. His is not the world of large money center banks. Rather, Mr. Crutchfield's world is made up of small investors, men and women seeking to finance their own homes, and small and medium sized businesses. I commend his testimony to my colleagues.

Mr. Chairman, I would also like to praise your efforts and those of ranking minority member Senator Garn on joining together to present the committee with an excellent bill that takes the important first step of permitting banks broader securities powers while at the same time establishing crucial safeguards for the safety and soundness of our banks. Moreover, I commend Senators Graham's and Wirth's initiative in distilling the Corrigan plan into a legislative proposal. I believe the Graham-Wirth bill addresses a number of critical issues, including access to the payments system and the need for greater coordination of our financial services regulators. I also appreciate the efforts of Senators Cranston and D'Amato in introducing more comprehensive legislation that embodied the proposal put forward by the Financial Services Council. These bills demonstrate the committee's awareness that the reform and change embodied in the repeal of the Glass-Steagall Act must be accompanied by a structure to support the altered financial environment.

In this time of extreme financial volatility, we must act responsibly and carefully consider the effects of the reforms being proposed. By the same token, we must not shy away from long over due reforms simply because they involve hard choices and difficult compromise. I am committed to examining the many questions that a reform of our financial services industry raises and to pushing for legislation that will create greater competitive parity between this country's banking and financial services industry.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. In recent weeks, we have heard speculation, then rumor and next, most likely a confirmation of these rumors, that many countries in Latin America are going to engage in a "moratorium" on the billions of dollars in debt payments they owe American banks. Earlier this year, Brazil imposed such a moratorium on debt payments. I would suggest to my colleagues that the Latin American debt payment moratorium and the consequences of that moratorium on the U.S. financial system merit as much, or perhaps even more, of our attention than the moratorium we imposed under the Competitive Equality Banking Act [CEBA]. When the CEBA moratorium expires, the world will not come to an end. However, a concerted refusal by Latin American debtors to pay even interest payments on their debt could have serious consequences on the safety and soundness of our financial institutions and depositor confidence in those institutions with large loans to Latin American countries.

Due to the potential impact of a Latin American loan default and the precedent such a default sets for other large borrowers, I think it is imperative that this committee designs a statutory scheme that permits, and perhaps even promotes, the infusion of new capital into the banking system. I doubt that the infusion of capital into the banking system which supposedly will occur if banks are granted a few securities powers will be adequate in the face of the Latin American debt crisis, the farm loan crisis and the crisis confronting energy lenders.

The infusion of adequate capital which is needed in the banking industry and which, as the events of October 19, 1987, have demonstrated, are needed in certain segments of the securities industry can only come from sources outside the banking and securities industries. The recognition of the need for new and greater sources of capital compelled Senator Cranston and me to introduce the Depository Institution Affiliation Act (S. 1905). The Depository Institution Affiliation Act establishes a regulatory framework which permits the infusion of capital from outside the banking and securities industries by establishing an alternative regulatory framework which commercial entities, existing bank holding companies and other providers of financial services may—not must—opt into.

I believe that the broader approach to financial restructuring merits serious consideration by the Senate and the House. Enactment of this legislation prior to the expiration of the moratorium on March 1, 1988, is just as politically feasible as the enactment of any other proposal presently before the committee. Many witnesses have urged us to adopt S. 1886 because it is an adequate first step toward financial restructuring. I cannot accept these arguments because there is no such thing as an adequate first step in the consideration of comprehensive reform. The reform of Glass-Steagall represented by S. 1886 and to a lesser extent by S. 1891 are piecemeal attempts at reform. Although these bills are not inconsistent with the goals and public policy of S. 1905, they do not create true competition in the financial services industry because they do not create a two-way street. Finally, I doubt that our efforts toward truly comprehensive reform will be facilitated by enactment of piecemeal reform. Those who benefit from piecemeal reform will in all likelihood forget about the legislation process until they find that the few new powers they obtained this year do not provide the expected bonanza in increased revenues. Then they'll come back for more "reform". However, the political climate in Washington and the mood of this committee might not be as accommodating as it is at present.

Therefore, Senator Cranston and I feel obliged to live up to the pledge that we, as members of the committee, made upon the imposition of the moratorium contained in the Competitive Equality Banking Act. At that time we pledged to develop a comprehensive statutory framework to modernize our financial system. We intend to fulfill our commitment despite the fact it may not be the most politically expedient approach.

STATEMENT OF SENATOR JOHN H. CHAFEE

Senator CHAFEE. Mr. Chairman. I am pleased that this week we will hear from the actual practitioners, those who will be directly involved from a profit-and-loss point of view, with regard to changes that this committee will make in the Nation's banking and securities laws.

We must remember that the chief beneficiaries of our efforts should be the consumers—to offer them the widest range of services at the most reasonable cost, consonant with preserving safety and soundness in the U.S. banking system. The structure of the future world of financial services is also important, because the direction and the overall vision are matters on which we should spend time, but not at the cost of legislative inaction. Therefore, let us consider a few crucial issues.

First, safety and soundness. The commercial banks are taken to task by some for the increased risk that expanded securities activities are expected to cause them. Yet banks can currently provide many of these services abroad and I am not aware of any record of either poor management performance on an industry-wide scale or an extraordinary infringement of safety and soundness. Furthermore, commercial banks in the United States have performed the limited securities activities allowed them without forfeiting the public's respect.

There are also probably some people for whom there can never be enough safety and soundness. Yet there cannot be a 100 percent certainty level short of limiting commercial banks to being passive recipients of deposits and being unable to even make loans. One could make the same request that verification be positively ensured in advance so that no nuclear weaponry would ever be concealed. But this cannot be.

So we try to legislate, for safety and soundness, sufficient safeguards to reach a comfort level that is acceptable. These safeguards should include a firewall between the bank and its securities affiliate, greater disclosure and supervision, and stronger penalty and enforcement provisions.

The Proxmire-Garn bill discusses the first two but does not touch on the last one—penalty and enforcement provisions. This is a matter that I feel on this committee we give very little attention to and the D'Amato-Cranston bill should be commended for bringing this matter forward. My concern, Mr. Chairman, is that when the civil penalty is more often than not $1,000 per day for infractions, and criminal penalties are rare, where is the intentional discouragement in advance of illegal activities, when the upside is often so much more attractive? Insider trading a la Boesky is not an isolated case. Look at the lawsuits being brought in the savings and loan industry, where actions at one institution have recently necessitated an injection by FSLIC of $1.3 billion.

Let us make all aware in advance that certain activity will not be tolerated by letting them know the penalty. This should also help alleviate some of the regulatory banking and security staff time that is consumed in prosecutions that might have been averted through prior knowledge of these penalties. And I hope you will not style me an old testament prophet if I say that the threat of incarceration concentrates the mind wonderfully.

Second, consumer benefits. I am not aware, Mr. Chairman, of any evidence that demonstrates that commercial bank entrance into the broad range of securities activities would be financially harmful to the consumer. (The only direct worry voiced concerns tie-ins and I feel these can be dealt with, although there is hardly a bright line in this matter.) The evidence consists mostly of conflicting claims as to the extent of the direct financial benefits, not as to whether the benefits exist or not. Let us not parse the poetry too closely here, or we will lose sight of the larger issue.

Third, a rewrite of the Glass-Steagall Act versus launching a brave new financial world. I am pleased that Senators Graham, Wirth, D'Amato, and Cranston, have seen fit to bring forward bills that posit approaches to restructuring the whole financial services industry. These cannot but help greatly in leading informed debate on the issue. Nevertheless, we must all be cognizant of the need to move forward, and any step, however small, that moves us in the generally agreed direction should not necessarily be dismissed as insufficient. The Glass-Steagall rewrite, advocated in the Proxmire-Garn bill, offers a very acceptable halfway house along the road to that ultimate vision. And the bill is certainly amendable, at least in the matter I raised earlier. Moreover, safety and soundness itself militates in favor of not adopting too broad and sweeping a change.

Fourth, balanced legislation. It has been charged that the Proxmire-Garn bill creates a two-way street in name only, that the benefits for investment banks are negligible compared to those for commercial banks. If this is so, then we need guidance from the securities industry as to what changes in the law would positively assist them to improve their ability to compete internationally. As you may remember, Mr. Chairman, I asked this question of Mr. John Weinberg, the senior partner of Goldman Sachs, in committee hearings this past summer, and I have forwarded his response to the SEC, the Treasury and the Federal Reserve for their considered opinion. Certain suggestions that he made may well be acceptable and be able to be implemented. I am hopeful that the security industry representatives here today will adopt a similarly constructive approach so that the bill we report out of committee will have a positive sum outlook.

Mr. Chairman, these are important concerns that I have. I look forward to the testimony of the witnesses and the subsequent question-and-answer period to discuss them more fully. Thank you, Mr. Chairman.

The CHAIRMAN. The first witness is Mr. E. E. Crutchfield, Jr., chairman and CEO of the First Union Corp. of Charlotte, NC, representing the American Bankers Association, is that correct?

Mr. CRUTCHFIELD. We speak actually for ourselves, sir, I do, but on behalf of the Proxmire-Garn bill.

The CHAIRMAN. Very good. Go right ahead. As long as you're speaking in behalf of the bill, then you're a good guy. Go ahead. [Laughter.]

STATEMENT OF E. E. CRUTCHFIELD, JR., CHAIRMAN AND CEO, FIRST UNION CORP., CHARLOTTE, NC

Mr. CRUTCHFIELD. Thank you. I appreciate that endorsement.

It's a pleasure to be here. It's indeed an honor to be here and I appreciate the opportunity to testify on the need for the reform of the Glass-Steagall Act.

My name is Ed Crutchfield. I'm chairman of First Union Corp. headquartered in Charlotte, NC. Just a bit about First Union. It's a $25 billion bank holding company with banks in North Carolina, South Carolina, Georgia, and Florida. It sounds extensive and in some respects it is, but the heart of our operation is community oriented and it's from that perspective that I will make my comments today.

As a major regional bank, we are acutely aware of the larger corporate financial imperatives that make these hearings and, in fact, make banking and securities restructuring necessary. But because First Union's banking structure is really a network of community banks and branches, we are even more keenly aware of the local need for banking regulation.

That awareness provides us with a very lucid perspective on the need for Glass-Steagall Act reform. The need arises essentially from three areas: households, small and medium sized businesses, and the communities in which we operate.

S. 1886 BEST ADDRESSES CONCERNS OF SAFETY AND SOUNDNESS

Senate bill 1886, the Financial Modernization Act, recently introduced by Chairman Proxmire and Senator Garn, is an excellent bill. In my judgment, S. 1886 best addresses the safety and soundness concerns of the public, regulators, and financial institutions and executives.

There's an understandable desire to deal with a lot of other questions, a lot of broader issues, such as bank and commercial firm affiliations, insurance brokerage, underwriting and real estate activities. My understanding is that a lot of these questions are specifically addressed in other bills. They have some excellent provisions, but I would urge the committee to act now on Glass-Steagall reform as proposed in the Proxmire-Garn bill. In my view, the Proxmire-Garn bill in no way precludes future action or consideration of these other issues.

Just one note of caution. I strongly urge that the committee not extend the moratorium or include any form of moratorium in the legislation you are now considering.

The interest of First Union's customers, including individuals, businesses and local governments would be greatly harmed by any extension of the moratorium. We must proceed expeditiously because in the securities area the needs of many customers are now being met by nonbank competitors at excessive prices.

Let me give you one example. As background, First Union's investment performance in its trust division is in the top 5 percent of all equity managers, including mutual funds and securities firms. A few weeks ago, a major metropolitan newspaper in North Carolina published an article about First Union's investment performance in the trust area.

The article erroneously gave the impression that First Union could accept trusts as small as $1,500. The result was that we were flooded with requests to open small trust accounts of $1,000, $2,000, $5,000, and $10,000. Unfortunately, we were forced to tell the callers that we could not manage accounts that small. In order to cover even minimal legal and administrative expenses, we would have to operate what is essentially a mutual fund and currently, as you know, that's illegal for banks.

Clearly, there is a strong demand for our investment management services which we are now absolutely prohibited from providing. What that means to us is that 98 percent of our customers cannot use our investment services which have proven to be effective and could be offered easily at our 730 branches around the Southeast.

It's very difficult to explain to a person, how we can manage somebody's money if he has $250,000 but we can't manage somebody's money who only has $1,500. They don't believe that that's against the law.

Let me expand on that point for just a moment. Most of the towns we are in, are small towns, 10,000, 5,000 or 15,000 population. They do not have a local contact for investing in mutual funds. Under current circumstances, what they wind up doing is either driving to a large city or calling an 800 number in the newspaper to find out some place that they can put $10,000 in a mutual fund.

A 1987 household survey—I've described this in the written statement that I submitted—found that 40 percent of households expressing an interest in purchasing mutual fund shares would prefer to invest through a local bank or a thrift for that matter, but do it through an institution where they can get eye-to-eye contact. These people tended to be moderate income, conservative investors who want to deal essentially with people they know and, as I've said, they cannot do so at this time.

The Glass-Steagall Act similarly prevents us from providing municipal revenue bond financing services to local communities. In some of our smaller Florida communities we offer municipal finance advisory services to help the local governments deal with the funding problems they face as a result of rapid growth. Most times these needs can be best met with municipal revenue bonds. Under current restrictions, when this course is indicated, there is now one of two outcomes. Either we step aside while an out-of-State investment banker underwrites and distributes the bonds at what we think is a higher cost than we would charge if we were allowed to do it ourselves, or we have to help the community arrange some other kind of jury-rigged financing less preferable, because the community is so small that we can't find an investment banker who's willing to deal with it at all.

If we had revenue bond underwriting authority we could better serve our customers and I believe underwrite the bonds at reasonable costs.

It's only natural that some of you may be concerned that I'm prejudiced. Therefore, let me offer the conclusions of a knowledgeable and impartial observer. I've included several in my written statement, but I'd like to highlight just one in this testimony.

The National Association of Home Builders can certainly provide expert comment on home mortgages. The association estimates that if banking organizations were permitted to underwrite mortgage-backed securities, the increased competition would save homebuyers a lot of money. They say the savings could be as much as $1,000 in home financing costs over the life of a typical $100,000 privately insured mortgage.

I recognize that the securities industry has attempted to disquiet legislators by implying that consumers could somehow be injured by bank entry into securities activities, but they have failed to offer one shred of concrete evidence or even a believable scenario.

As table 3 of my written testimony shows, 20 of the largest U.S. securities firms are already affiliated with banks without injury to consumers. In table 4 of that same testimony I've listed the securities firms that are already affiliated with foreign banks.

Clearly, if there were any validity to the arguments that involvement of banks in the securities business was in any way injurious to consumers, strong evidence by this time surely would have surfaced. It has not.

Concerns have been raised that the banking system would become less secure by revision of Glass-Steagall. Actually, the opposite is true. Let me highlight here just a couple of points that are further explained in the written testimony I've provided.

First, banks already have extensive experience in underwriting U.S. government securities.

Second, the skills that regional banks have already acquired in areas such as the public bond markets are very easily transferrable to activities in the new markets that S. 1886 envisions.

Third, the provisions provided by S. 1886 are more than sufficient to preclude any possible abuses of securities operations by banks.

Thus, both the taxpayers and the American consumers are well protected.

In conclusion, Mr. Chairman, let me just say that the decision of the Congress on further bank deregulation should not focus only on competing industry groups. Your attention should clearly be focused—and I'm sure it will be—on the consumer and the American people. In that respect, passage of S. 1886 would enable your constituents to enjoy the benefits of greater financial stability, greater availability of services and products on Main Street and not just on a couple of corners of Wall Street, and better services at lower costs.

When the issue is viewed in this context, the merits of legislation such as the Financial Modernization Act are overwhelmingly evident.

I appreciate the opportunity to comment on this legislation. Thank you, sir.

[The complete prepared statement of Edward E. Crutchfield, Jr. follows:]

Statement of

Edward E. Crutchfield, Jr.
Chairman of the Board
First Union Corporation
Charlotte, North Carolina

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

December 8, 1987

Chairman Proxmire, Senator Garn, and other distinguished Committee Members, it is an honor and a pleasure to be here today to testify on the need for Glass-Steagall Act reform.

My name is Ed Crutchfield, and I am chairman of the First Union Corporation, headquartered in Charlotte, North Carolina.

First Union is a $25 billion bank holding company represented by banks in North Carolina, South Carolina, Georgia, and Florida. While this sounds extensive, and in many respects it is, the heart of our operations is community oriented.

Our network of banks is really a network of community banks and branches. We are acutely aware of the larger corporate financial trends that make banking and securities restructuring necessary. However, our local orientation provides us with a perspective on the need for Glass-Steagall Act reform that arises from the particular needs of households, small and medium-sized businesses, and growing communities.

S 1886, the Financial Modernization Act, recently introduced by Chairman Proxmire and Senator Garn, in my judgment amends the Glass-Steagall Act in a way that addresses the needs of consumers, businesses, and local governments. It also addresses the safety and soundness concerns of the public, federal regulators, and financial executives. Legislation of this nature is what is needed and should be enacted.

There is understandably a desire to deal also with the broader questions of bank and commercial firm affiliations, insurance brokerage and underwriting, and certain real estate activities. As I understand it, these matters are in a fashion dealt with in S 1891, the Financial Services Oversight Act, and S 1905, the Depository Institutions Affiliation Act, introduced respectively by Senators Graham and Wirth, and by Senators D'Amato and Cranston. I urge this Committee to act now at least on Glass-Steagall reform as is done in the Proxmire-Garn bill. Glass-Steagall reform is in no sense inconsistent with any further actions you may want to take with respect to the more general question of permitting commercial enterprises to affiliate with federally-insured banks.

I specifically urge that the Committee not extend the Moratorium or include any form of it in the legislation you are now considering. The interests of First Union's household, business, and governmental customers would require that we oppose adoption of any legislation containing some form of service limiting moratorium.

My reasons for saying this have to do with the present limits on bank service opportunities. The limits should not be tightened. Instead, our financial service opportunities should be permitted to adjust to customer demand and market innovations.

In the securities area, many customer needs are going unmet or are being met by nonbank competitors at prices that are higher than necessary.

Let me give you an example. Some time ago, a major metropolitan newspaper in North Carolina published an article about First Union's trust services. The performance of our equity investment managers, like those of numerous other banks, is quite good. SEI, a major independent investment performance evaluation firm, reports that our equity management record over the past five years puts us in the top 5 percent of all money managers, including mutual funds and securities firms.

The article, unfortunately, gave the impression that we could accept trusts as small as $1500. The phone rang off the hook for over a week with requests to open small trust accounts! We had to tell the callers that we could not manage accounts that small -- to cover even minimal legal and administrative expenses we would have to operate what is essentially a mutual fund, and that would be illegal.

Clearly there is strong demand for our investment management services. But we can't provide them to low and moderate income people -- the Glass-Steagall Act effectively prohibits us. For First Union, the Glass-Steagall Act means that 98 percent of our customers cannot use our investment services. If we had mutual fund sponsorship authority, they could.

This Committee needs to understand that the people in the small towns we serve do not have a local contact for investing in mutual funds. They have to travel significant distances or use 800 numbers and talk with people at the other end of a telephone line in a remote city. The desire of these people to make investment decisions face-to-face is important and is reflected in a comprehensive 1987 Market Facts household preference survey. That survey found that 40 percent of households identified as "potential prospects", that is, those expressing an interest in purchasing mutual fund shares within the next six months, would prefer to invest through a local bank or thrift institution.

These people tended to be moderate income, conservative investors, who like to deal with people they know personally.

The Glass-Steagall Act similarly prevents us from providing municipal revenue bond financing services to local communities.

In some of our smaller Florida communities we offer municipal finance advisory services to help the local governments deal with the funding problems they face as a result of rapid growth. We work for months with clients, evaluating and planning how they can meet their community improvement financing needs. Most often these needs can be best met with municipal revenue bonds. When this is the case, there are one of two outcomes. Either we have to step aside and watch while out-of-state investment bankers underwrite and distribute the bonds at a higher cost than would be the case if we could compete for the opportunity to perform this service. Or we have to help the community arrange other less preferable financing because the community is so small we cannot find an investment banker willing to work with our client. If we had revenue bond underwriting authority, using less preferable financing would not be necessary. We would do it ourselves -- the wellbeing of our banks is directly dependent on the growth and development of the communities we serve.

Gentlemen, the Glass-Steagall Act imposes absurd limits on us. Right after this hearing I could go to a telephone and purchase $1 billion in government securities for our banks. The market value of those securities on a quiet day could easily decline $10 million. We manage these risks sucessfully every day. But because of Glass-Steagall, we are prohibited from taking even the de minimus underwriting risk on a $5 million revenue bond issue. Small communities across the country and the people that live in them are the ones that pay for this unnecessary restriction.

I am aware that as policy-makers you must carefully question whether permitting bank affiliations with securities firms would result in the provision of municipal revenue bond underwriting, mutual fund sponsorship and distribution, and other securities underwriting services at a lower cost. If the effects of increased competition from banking entrants into the securities area are fully weighed, however, I think the answer is undeniably yes.

First, consideration has to be given to the fact that the securities industry is highly concentrated. The five largest securities firms in each business category control 95 percent of the commercial paper market, 81 percent of the mortgage and asset-backed securities underwriting market, and 72 percent of the corporate debt underwriting market. These levels of concentration alone suggest the likelihood that greater competition would reduce underwriting spreads and other service fees.

Second, attention should be given to evidence from other markets.

- In the Eurobond market where banks can compete, concentration is not a concern -- the top five underwriters account for only about 35 percent of the market.

- In 1982 when Japanese banks were permitted to make markets in government securities in the over-the-counter market, bid-ask spreads dropped immediately from 40 to 20 basis points and remained at approximately that level thereafter.

- Underwriting fees in the general obligation market where banks can participate are significantly lower than in the revenue bond market where banks currently cannot participate fully. In fact, the National Governor's Association estimated that lack of competition in the revenue bond market may add as much as $5 per $1,000 of par value to the cost of underwriting revenue bonds.

Third, consideration should be given to employee compensation. In the securities industry employee compensation levels are legendary. They are probably a result of concentration and are surely reflected in the fees and spreads charged by investment banks. A New York Times business section article last week reported that security firm employee compensation as a percent of total revenues exceeds 39 percent. As a bank executive I was amazed. From our own substantial investment and trading responsibilities I can tell you for a fact that Wall Street salary levels are needlessly, perhaps absurdly, high. They are more than twice the level for banks. A comparison of bank and securities firm compensation levels over the past four years is shown in Table 1 attached to my statement. While I expect recent events will moderate securities firm compensation levels, increased competition from lower cost and more efficient bank providers of securities services would bring underwriting and distribution costs down to an appropriate market-determined level.

Fourth, attention has to be given to the judgments of independent and knowledgeable observers.

- According to estimates based on National Governors Association figures, if banks could underwrite municipal revenue bonds, State and local governments could save between $400 million and $500 million per year in borrowing costs.

- If banking organizations were permitted to underwrite mortgage-backed securities, the National Association of Homebuilders estimates that the increased competition would enable a homebuyer to save as much as a thousand dollars in home financing costs over the life of a standard $100 thousand privately-insured mortgage.

Admittedly, the amount of consumer benefits that would come about from Glass-Steagall reform cannot be firmly established. In my judgment the available evidence indicates that the benefits would be substantial. The consumer and public benefits of Glass-Steagall reform are summarized in Table 2.

I am also influenced by two other pieces of evidence that I think are persuasive --

The first is this. I am struck by the fact that the opponents of Glass-Steagall reform have offered no evidence to indicate that bank entry into the securities business would be injurious to consumers. And of course they can not. As Table 3 in my statement shows, 20 of the largest U.S. securities firms are affiliated with banks. Table 4 lists the U.S. securities firms which are affiliated with foreign banks.

The second piece of evidence is this. U.S. banks have extensive securities underwriting experience. First Union alone in its trust and bank investment operations manages over $15 billion. First Union and other U.S. banks underwrite and distribute all forms of U.S. government securities in the United States, and as Table 5 shows, many of the largest U.S. banks are affiliated with full-service securities firms abroad. To my knowledge all available indications are that their operations are soundly managed in very competitive international markets.

The presence of commercial banks in the U.S. government bond market has added immeasurably to the depth and breadth of that market. It is clear to me that the same would be true of other markets, such as the revenue bond market, if banks were permitted to enter them. Regional banks such as First Union are expert in the securities markets in which they now operate. This skill and efficient professionalism is easily transferable to new markets if done thoughtfully and patiently.

In addition to the likely consumer benefits I have mentioned, Glass-Steagall reform would, in my judgment improve financial market strength and stability. The securities markets would be better capitalized and be more liquid as a result of an increased number of thoroughly regulated and supervised bank participants.

The opponents of Glass-Steagall reform disagree with this. Their view is that permitting banks to affiliate with securities firms will result in a weaker rather than a stronger financial system. They specifically point to conflicts of interest as a source of problems.

This is not a new concern. Banks and their affiliates within a bank holding company are faced with such conflicts continuously, and an extensive regulatory and supervisory framework has been developed to monitor and prevent abuses of them.

The existing statutes and regulations, in my judgment, very thoroughly prevent affiliates within a holding company from abusing or exploiting their corporate relationships. A listing of these safeguards assembled by the Minority Staff of this Committee is provided in Table 6, and as you can see the safeguards are quite extensive.

In my own judgment existing safeguards are ample and sufficient. Nevertheless, I can, with one exception, accept and encourage adoption of the additional bank-securities affiliate safeguards contained in S 1886. They seem to me to address fully the concerns of those who are thoughtfully hesitant about permitting bank and securities firm affiliations.

The one exception is the provision prohibiting officer and and director interlocks between bank and securities affiliates. In my judgment, this prohibition is unnecessary and is potentially an obstacle to efficient management. Management talent is very scarce. Preventing us from sharing the talent we have may not be financially sound. You have seen the need to permit such interlocks in the case of smaller banking institutions. The problem is the same, and in some respects more acute, for regional institutions. I urge you to reconsider this restriction and permit the sharing of scarce management resources.

In conclusion, Mr. Chairman, it is my belief that the legislative decision you and your colleagues face should not be based on a choice between competing industry groups but rather should be based on enabling your constituents to enjoy the benefits of greater financial stability and improved financial services at lower cost. When the issue is considered in this context, the need for enactment of legislation such as the Financial Modernization Act is quite clear.

Thank you.

TABLE 1

EMPLOYEE COMPENSATION AS A PERCENT OF TOTAL REVENUES AT COMMERCIAL BANKS AND SECURITIES FIRMS

Year	Commercial Banks[1]	Securities Firms[2]
1987[3]	14.9	39.3
1986	15.4	38.7
1985	14.2	37.8
1984	13.3	37.6

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[1] Data on commercial banks comes from the Consolidated Reports of Condition and Income submitted to the Federal Deposit Insurance Corporation.

[2] Data on members of the New York Stock Exchange which do business with the public was derived by Lipper Analytical Securities Corporation from Focus Reports.

[3] January through June 1987 for commercial banks; twelve months ended September 1987 for securities firms.

TABLE 2

GLASS-STEAGALL REPEAL, CONSUMER BENEFITS AND FINANCIAL STABILITY

I. Consumer Benefits

A. Mutual Funds

1. Shareholders are paying too much in sales charges and administrative fees for mutual funds. Sales charges or "loads" range from 4 percent to 8 percent of the amount invested. This means that for a $100 expenditure, only from $96 to $92 is actually invested. These sales charges cost consumers between $3 billion and $6.3 billion during the first six months of 1987 alone. In addition, almost one half of the 385 mutual funds surveyed by Business Week imposed administrative fees greater than 1 percent of total fund assets -- most banks charge less than 1 percent for comparable services.

2. Allowing banks to sponsor mutual funds would reduce marketing and administration costs by increasing competition.

3. The existing bank branch network -- 56,000 offices serving urban and rural areas -- is an ideal distribution system which would make mutual fund services more convenient for constituents.

4. Superior investment performance of bank-managed collective investment funds suggests that bank sponsored mutual funds may offer constituents higher investment returns.

5. Surveys show that banks are the preferred supplier of mutual fund services for many consumers -- particularly moderate income consumers.

B. Asset-Backed Securities

1. The National Association of Home Builders estimates that bank entry into mortgage-backed securities underwriting would save consumers as much as $1,000 on a $100,000 mortgage. The reduction in mortgage interest rates and monthly payments would also make home-ownership possible for more families.

2. Lower mortgage interest rates would stimulate residential construction, resulting in more jobs and increased tax revenues.

3. Private mortgage and asset-backed securities underwriting is highly concentrated, keeping the cost of mortgage credit higher than it should be.

4. Bank participation in underwriting asset-backed securities would increase competition, reduce underwriting fees, improve liquidity and encourage innovation resulting in lower borrowing costs for constituents.

C. Commercial Paper

1. Five securities firms control 95 percent of the market for dealer-placed commercial paper. Increased competition from bank participation is likely to reduce costs and improve service for issuers.

2. The loss of prime commercial customers leaves banks with a higher risk profile, making the industry less stable and leading to higher costs for bank borrowers. Underwriting commercial paper would allow banks to reduce operating risk by earning fee income and maintaining valuable customer relationships.

3. Banks could extend the benefits of commercial paper borrowing to more credit-worthy smaller business customers who currently do not have access to the market.

D. Municipal Revenue Bonds

1. Government experts estimate municipalities could have saved some $480 million if banks had been able to compete in underwriting revenue bonds in 1986.

2. Bank participation would improve secondary market liquidity, lower underwriting fees, and increase the financing alternatives of small communities.

3. The National Governors Association, National Conference of State Legislators, National League of Cities, National Association of Counties, U.S. Conference of Mayors, and Government Finance Officers Association all support bank underwriting of revenue bonds.

E. Corporate Securities

1. The market for corporate securities underwriting is highly concentrated. Bank participation would increase competition leading to lower underwriting fees and improved service to issuers.

2. Bank competition may help price issues closer to their true market value -- a direct benefit to issuers.

3. Smaller firms and first time issuers would enjoy improved access to securities markets if banks could participate, especially in light of the decline in the number of regional securities firms.

II. Financial Stability

A. Allowing banks to serve their customers and diversify their sources of income would strengthen the financial industry and enable banks to continue to play a key role in the economy.

B. Banking industry participation would broaden and deepen securities markets by providing increased capital and liquidity.

C. Competition from banks would create more innovative and efficient securities markets.

D. Bankers would bring significant financial knowledge and expertise to securities markets.

E. Allowing banks to compete freely in domestic securities activities would help the U.S. remain competitive in global financial markets and would encourage employment in the U.S.

TABLE 3

AFFILIATIONS BETWEEN U. S. SECURITIES FIRMS AND U. S. FEDERALLY-INSURED DEPOSITORY INSTITUTIONS

Securities firm	Insured Depository Institution*
American Express Company IDS Securities Corp. The Robinson-Humphrey Co., Inc. Shearson Lehman Brothers, Inc.	Advisory Bank & Trust Co. American Express Centurion Bank Boston Safe Deposit & Trust Co. Savings Bank Trust Co., NW
Bear, Stearns & Co. Inc.	Custodial Trust Company
Dean Witter Reynolds Inc.	Greenwood Trust Company Hurley State Bank
Drexel Burnham Lambert Incorp.	Commercial Trust Co. Harbor Trust Company
Dreyfus Corp.	Dreyfus Consumer Bank
Eaton Vance Distributors, Inc.	Investors Bank & Trust Co.
Federated Securities Corp.	Liberty Bank and Trust, NJ
The First Boston Corporation	Universal Trust Co.
First Investors Securities Corp.	First Financial Federal Savings and Loan Association
Franklin Distributors Inc.	Pacific Union Bank and Trust Co
Goldman, Sachs & Co.	Broad Street Bank and Trust Co.
E. F. Hutton & Company Inc.	E. F. Hutton Bank
The Illinois Co., Inc.	Land of Lincoln Savings & Loan
John Hancock Subsidiaries, Inc. Sutro & Co. Incorporated Tucker, Anthony & R.L. Day, Inc.	First Signature Bank & Trust Co
Kidder, Peabody & Co. Incorp.	Monogram Bank
Merrill Lynch & Co., Inc.	Merrill Lynch Bank & Trust Co.
Prudential-Bache Securities Inc.	Prudential Bank and Trust Co.
The Travelers Corporation Dillon, Read & Co. Inc. Securities Settlement Corporation	Massachusetts Co., Inc.

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* Deposits insured by the FDIC except First Financial Federal Savings & Loan Ass and Land of Lincoln Savings & Loan, whose deposits are insured by the FSLIC.

The CHAIRMAN. Thank you very much, Mr. Crutchfield.

Our next witness is the president of the Bryn Mawr Trust Co., Bryn Mawr, PA, Robert Stevens.

STATEMENT OF ROBERT STEVENS, PRESIDENT, BRYN MAWR TRUST CO., BRYN MAWR, PA

Mr. STEVENS. Thank you, Mr. Chairman.

Senator Proxmire, Senator Garn, Senator Riegle, I'm happy to be here this morning to try to persuade you to help the banks continue to serve their communities.

I represent the Bryn Mawr Trust Co. We are a $250 million bank that serves the western suburbs of Philadelphia. We operate five full service branches. We operate two facilities in life care communities in our market area, and we also operate on two college campuses automatic teller machines.

We have been a trust company and commercial bank for 98 years. We serve our community with a fierce pride in our independence. We have been subject to two takeover battles in the last several years. The last one included a full-blown proxy fight that lasted 2 years. We've looked right down the barrel of the gun, and we are intent on maintaining our independence and on continuing to serve our communities.

I'd like to tell you a little bit about what I mean when I say "serve our community". I polled our officers and directors—they total in number about 55 men and women. I found that we are on the library board. We're represented on the hospital board. We're represented on five school boards, four of them as chairman, president or treasurer. We're involved in eight church related boards, including church investment committees. We serve on three fire companies, two college boards of trustees, one junior college advisory board, two museum boards, four local governments as commissioner or committeemen, the YMCA board and the Boy Scout Council board in our area.

In addition, this year the bank will spend $75,000 in charitable community contributions. About 40 percent of that goes to a series of summer concerts that we run outdoors. We had in excess of 3,000 people from our community enjoy these free concerts last summer.

In short, gentlemen, we represent something to our community. We believe that we serve it well, and we want the chance to continue to do that.

Our bank has done very well over the decade of the 1980's—our assets have grown at a rate of 18 percent. Now if you'll turn to the statement of Charles Pistor, which I believe you have, exhibit 5 shows the rate of growth of other financial institutions for the period 1980–1985. The bar on the left representing commercial banks shows an annual growth rate of about 8 percent. On the other hand, mutual funds have grown or an annual rate of 33 percent. Our bank split the difference. We grew at an 18 percent rate—strong, solid numbers.

But because of the restrictions on our lines of revenue, we have only been able to add back 7 percent to our capital over this same period of time. So the proportion of capital to the assets the bank holds is decreasing as we go forward.

Because we started from a strong capital base, we are all right for a while. But that while is running out. The reason for the increase in assets and the slower rate of growth of capital is that our net interest margins—I submit because of the competition—over this 8-year period have dropped 35 percent. The net interest margin is off 35 percent during the decade of the 1980's.

We need new lines of revenue in order to support our capital, in order to continue to provide the community and our customers the services we now offer.

I looked about competition. I got the yellow pages out for what they call the Eastern Main Line. It covers about half our market area. There were 20 banks listed under banks in the yellow pages. Eleven of them were commercial banks, five were savings and loans, three mutual savings banks, and one listing under banks was the GMAC Mortgage Co. I looked under stock brokers. There were 22 listings. We face an abundance of competition in what isn't even the entire market that we serve.

I'd like to finish my statement this morning with a story. A woman we'll call Mrs. Phillips came into the bank. She had decided—this was some months ago—but she had decided that she wanted to rearrange her investments. She thought the stock market was getting a bit overpriced and wanted to buy some gold stocks. She came into the bank to seek my advice about buying gold stocks. I regretted to have to tell her that we were precluded from giving her any advice about gold stocks. Though we have three investment people in our trust department who are professional, competent, and fully capable of giving that advice, we are restricted by really ancient laws from providing her this advice.

She had to leave. She was unsettled, banged her cane and walked out, saying that she had to go see the stock broker down the street. She had two choices. I don't know which one she chose, but I do know she was upset that the bank could not help her. She said she really didn't want to go see that stock broker, but she had to because we were precluded from giving her advice about gold stocks.

So I ask, gentlemen, that we kill the moratorium, not the banks; give us the powers we need to expand our lines of revenue so that we can continue to attract the capital necessary in our business. We need to continue to serve our community as we have. We need to continue to serve our customers. To do so fully we need additional powers.

Thank you very much.

The **Chairman**. Thank you very much, Mr. Stevens.

Last week before this committee, Chairman Ruder, Chairman of the SEC, recommended that the SEC Act of 1934 be amended to remove the provisions providing for bank exemption from broker-dealer regulation.

He said that the regulation of bank security activities under the Federal banking law is not an adequate substitute for Commission regulation.

Do you agree with Chairman Ruder's prescription for reducing investor protection problems?

Mr. CRUTCHFIELD. Sir, I don't have any strong feeling about that either way, but I would have no objection to that as a banker.

The CHAIRMAN. How about you, Mr. Stevens.

Mr. STEVENS. Not at all. I think it would be worthwhile to take a look at some of the things that the banks have done in the securities area over the years. We've been a trust company for 98 years and have dealt in securities for trust customers, and think you should take a look at what's being done properly and well by the banks.

The CHAIRMAN. I appreciate that.

POTENTIAL TIE-IN PROBLEM

Mr. Crutchfield, a bank with a securities affiliate in its sphere could tie-in underwriting services particularly when dealing with smaller firms. By tie-in, I mean make credit available contingent upon the use of the services of the securities affiliate even if this firm could buy investment banking services elsewhere on more favorable terms.

Do you believe that there's a potential problem? If not, why not? And if so, how could its impact be diminished?

Mr. CRUTCHFIELD. No, sir, I do not believe it's a potential problem. It seems to be a worry peculiar to bank enemies. We have laws on the books right now that prevent tie-ins generally.

Let me answer you this way, sir. We have a bank and we have about 10 nonbank affiliates. One of those is a mortgage banking operation. We sell certain kinds of insurance. I've been in this bank for 23 years and president of it for 13 years. I have never received a telephone call or a letter in my career from a customer complaining of any such pressure. The insurance people in our State have continuously at the State level tried to get us thrown out of the insurance business. They have not produced one witness that has complained about being forced to make a loan.

And finally, in our current state of affairs, we are so glad to see a bank customer show up that we're not about to force him to buy anything else.

The CHAIRMAN. But isn't there an implication that a person seeking credit may feel unspoken pressure to purchase other products.

Mr. CRUTCHFIELD. Well, sir, obviously I cannot be a mindreader about what they may think. I just don't think they think that. I think they get a loan. They're offered insurance. It's like buying a pair of shoes and the fellow asks if you want to buy socks. I don't feel that our customers, when they come in the bank, are saying, oh, oh, to get this loan we're going to have to take out insurance. Not nearly all of them do so. In fact, not a majority of them do so. So all I can say, sir, is I don't have any feeling that a problem, and I've never gotten that feeling from our customers.

The CHAIRMAN. Mr. Stevens, the Securities Industry Association on page 63 of its statement criticizes both the Proxmire-Garn bill and the Wirth-Graham bill because they hold open "an illusory promise of a two-way street."

Speaking specifically of the Graham-Wirth bill, the SIA says:

Because of the limited modification of the Bank Holding Company Act, affiliations of many existing securities firms as under the Proxmire-Garn bill would prevent them from benefiting from this bill, even if they were interested in doing so.

Now do you accept that SIA argument that because of this alleged problem both S. 1886 and S. 1891 are unfair to the securities industry?

Mr. STEVENS. Well, I'm not confident I have the complete background on that, but I believe they are referring to the fact that affiliations between banks and securities firms would be permitted, but that your bill, S. 1886, would preclude affiliations with other firms such as insurance.

The CHAIRMAN. Well, do you think the two-way street argument is an illusion?

Mr. STEVENS. We're actually all getting the same powers. The securities people are going to be able to own bank holding companies and operate a bank holding company and so will the banks be able to operate a bank holding company with a securities subsidiary. I don't think there's anything pushing back against the other.

The CHAIRMAN. Thank you very much. Before I recognize Senator Garn, I understand Senator Sanford has an introduction to make.

Senator SANFORD. Well, I wanted to welcome Ed Crutchfield, who is one of the leading citizens of North Carolina and head of one of the major banks in America and certainly has been a long-time leader. As a matter of fact, when he was first made president he was known as the "boy president." And he's been there that long as a leading citizen and a leading banker.

I'm delighted to have him here. They have certainly done an outstanding job in their own expansion and building in North Carolina and I'm delighted that he's here to testify. I regret that I'm not going to be able to attend the entire session this morning but I thank you for giving me a chance to welcome him to this committee.

The CHAIRMAN. Thank you, Senator.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Crutchfield, one of the arguments against the approach that any of these bills take is that it is only the big banks that want securities powers.

Do you accept that or do you believe that smaller banks in this country also desire to engage in expanded securities activities?

SMALL BANKS AND SECURITIES ACTIVITIES

Mr. CRUTCHFIELD. Well, there's no question that the smaller banks want to engage in securities activities. It is not something that should be done exclusively for big banks. If anything, the smaller banks are under even more of a profit squeeze than the larger banks; they're on the local scene and, as Bob Stevens has said, they've been in the trust business managing money for 98 years, a $250 million bank. So I think it's just a ridiculous argument.

Senator GARN. Mr. Stevens, do you feel that smaller banks have the expertise to deal in securities?

Mr. STEVENS. Well, we have the expertise to do some of the things that these powers will enable us to do I believe, Senator. I can't imagine us turning up the day after tomorrow and running E.F. Hutton. On the other hand, we could certainly benefit from the ability to securitize some of our paper, as an example. We could also do a nice business in mutual fund distribution, if not underwriting. We have the knowledge to do the underwriting, but the mechanics of it may be a problem.

We typically will grow a customer from a start-up or an embryo stage into something that's booming along; then we run out of ability to serve his credit needs. For us to be able to take his credit and others like it, and pool it together and put it into some kind of a securities instrument and be able to sell it locally to other buyers would be a terrific advantage for us, one we are precluded from doing right now. We can't securitize that credit. As I understand it, your bill would give us that power. It would be a wonderful advantage.

Senator GARN. Mr. Crutchfield, you object to the restrictions in the bill on officer-director interlocks. One proposal to modify this restriction is to allow interlocks as long as the majority of the board of directors of the securities firm is independent. Would you comment on that proposal?

Mr. CRUTCHFIELD. Yes, sir. Speaking personally, if I'm responsible for the company and my fortunes rise or fall on its success or failure—to have a rule that says cannot serve on the board of the subsidiary that we own 100 percent of and vote 100 percent of the shares of, to me, that's a little bit like too much candy for a nickel. In other words, a little bit too much of a good thing.

I have no problem with the idea of an outside board. I think the key issue is the protection. We have had subsidiaries for years. We have a mortgage banking company. Senator Sanford has left, but he was around when we had a real fire in 1975. Our bank holding company's mortgage company lost millions of dollars and pulled our entire holding company's earnings down 75 percent in one year. If there ever was a temptation to have the bank bail out an affiliate, that was it. The problems lasted for 3 years. We barely met our dividend in 1975 The "firewalls" in existance of that time were much less stringent than those being proposed in your bill. I guess having literally had the temptation pass right in front of our eyes to have one hand wash the other and having resisted that, because of obvious laws against it, we feel like those walls will hold up the next time around.

Senator GARN. Mr. Stevens, some argue that permitting banks to get into the securities field even through an affiliate of a bank holding company will lead to confusion, with people believing that their securities accounts would be federally insured.

Senator Proxmire and I have tried to be very specific about that in the bill. I would have preferred the option of conducting activities in a subsidiary of a bank, I yielded to the Senator on carrying them out only through affiliate of a bank holding company with what we consider severe restrictions on the ability of a bank to bail out that affiliate.

Do you consider this a problem or are the restrictions in the bill sufficient to solve this problem?

Mr. **Stevens**. Well, although I can't comment in great detail about all the individual pieces, my general sense is that it's appropriate to make it clear to customers that this is not an insured deposit.

I, for one, would never want to create that confusion with a customer between a bank deposit and a mutual fund or some other transaction with the securities affiliate. I think it's very worthwhile to keep those divisions between products clear.

Senator **Garn**. Well, I would just state that it's absolutely necessary to keep them separate.

Thank you, Mr. Chairman.

The **Chairman**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

SECURITIES ACTIVITIES AND SEPARATE AFFILIATES

If the bill that Senator Proxmire and Senator Garn have put forward were to become law, are both of you of the view that banks would be willing to put all present securities-related activity over into a securities affiliate?

Mr. **Crutchfield**. I haven't thought definitively through that, to be honest with you. But I would say there probably is a judgment line there. Let me give an example of what comes to mind and the reason I'm pausing there.

Our bank has about a $6 or $7 billion portfolio of securities that it manages for itself. Those, as you well know, are considered reserves to the bank. The Fed, I presume, would continue to regulate the bank. If those securities, the investment of deposits into reserves, which would then be a Government bond portfolio, are regulated by another regulator, that to me would seem pretty awkward. So to me there's some logical, reasonable place there that you preserve the continuity of what we've come to think of as a bank. But if you mean the underwriting, distribution activities and so forth, I would have no objection to those being separated into a separate subsidiary.

Senator **Riegle**. I take it the trust activities you would want to hang onto.

Mr. **Crutchfield**. Well, sir, when you say hang onto, as far as I'm concerned——

Senator **Riegle**. I mean keep them directly in the bank as opposed to being in the securities affiliate.

Mr. **Crutchfield**. I think so. I think that would be my preference. It's been OK for about 300 years and it's hard for me to see why it's dangerous.

Senator **Riegle**. Mr. Stevens?

Mr. **Stevens**. It strikes me, Senator, that you might want to look at some of the trust activities. In a bank our size, we deal primarily in investment work for the states or individuals. We're simply buying and selling securities through brokerage houses for them. There are some other activities I think in the way of corporate finance and so forth that might very well be put over into a securities subsidiary and regulated by the SEC.

Senator **Riegle**. Let me ask you something with respect to bank profitability, Mr. Stevens. I asked Chairman Greenspan of the Fed-

TABLE 4

AFFILIATIONS BETWEEN U. S. SECURITIES FIRMS AND FOREIGN BANKING ORGANIZATIONS[1]

United States operation	Foreign banking organization
ABD Securities Corporation	Bayerische Hypotheken Und Wechsel Bank AG and Dresdner Bank AG
Associated European Capital Corporation	Bayerische Vereinsbank AG and Creditanstalt Bankverien
The Bank of Tokyo Trust Co.	The Bank of Tokyo, Ltd.
BHF Securities Corporation	Berliner Handels - und Frankfurter Bank
Carroll McEntee & McGinley Inc.	Hong Kong & Shanghai Banking Corporation
Deutsche Bank Capital Corporation	Deutsche Bank AG
Drexel Burnham Lambert	Groupe Bruxelles Lambert[2]
EuroPartners Securities Corporation	Banco di Roma, Caisse des Depots et Consignations, Commerzbank AG, and Credit Lyonnais
The First Boston Corporation	Credit Suisse[3]
Goldman Sachs & Co.	Sumitomo Bank, Ltd.[4]
James Capel Securities Inc.	Hong Kong & Shanghai Banking Corporation
Julius Baer Securities Inc.	Baer Holding AG
Korea Associated Securities Inc.	Cho Heung Bank, The Korea Development Bank, and five other Korean banks
Paribas Corporation	Compagnie Financiere de Paribas
Sogen Securities Corporation	Societe Generale, Paris
Swiss American Securities Inc.	Amsterdam-Rotterdam Bank NV
Swiss Bank Corporation International Securities Inc.	Swiss Bank Corporation
UBS Securities Inc.	United Bank of Switzerland
Wall Street Clearing Company	Barclays de Zoete Wedd Ltd. Barclays Bank PLC

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[1] Derived from data provided by Morgan Guaranty Trust Company, the Securities Industry Association, and the U. S. Securities and Exchange Commission.

[2] Groupe Bruxelles Lambert owns a controlling interest in Banque Bruxelles Lambert and 55% of Bruxelles Lambert Holdings, which owns 28% of Drexel Burnham Lambert.

[3] First Boston Inc. owns The First Boston Corporation and 40% of Financiere Credit Suisse-First Boston (FCSFB). CS Holding owns the rest of FCSFB and Credit Suisse, a Swiss bank. Moreover, FCSFB owns 33.5% of First Boston Inc

[4] On December 5, 1986, Sumitomo Bank, Ltd., invested $425 million in a profits interest in Goldman Sachs & Co.

TABLE 5

AFFILIATIONS BETWEEN U. S. BANKS AND FOREIGN SECURITIES FIRMS

United States Bank	Foreign Securities Firm	Market
Bank of America, N.T. & S.A.	BA (Asia) Limited	Hong Kong
Bank of America, N.T. & S.A.	Bank of America International Limited	United Kingdom
Bankers Trust Company	Bankers Trust International	United Kingdom
Bankers Trust Company	BT Australia Limited	Australia
The Chase Manhattan Bank, N.A.	Chase Manhattan Asia Limited	Hong Kong
The Chase Manhattan Bank, N.A.	Chase Manhattan Bank (Switzerland)	Switzerland
The Chase Manhattan Bank, N.A.	Chase Manhattan Limited	United Kingdom
ChemicalBank	Chemical Asia, Limited	Hong Kong
ChemicalBank	Chemical Australia International, Ltd.	Australia
ChemicalBank	ChemicalBank (Suisse), S.A.	Switzerland
ChemicalBank	ChemicalBank International	United Kingdom
Citibank, N.A.	Asia Pacific Capital Corporation, Ltd.	Hong Kong
Citibank, N.A.	Citicorp Bank (Switzerland) AG	Switzerland
Citibank, N.A.	Citicorp Capital Markets Australia, Ltd.	Australia
Citibank, N.A.	Citicorp International Bank Limited	United Kingdom
Citibank, N.A.	Citicorp International Limited	Hong Kong
Citibank, N.A.	Citicorp International (Singapore), Ltd.	Singapore
Citibank, N.A.	Vickers Dacosta	Japan
Continental Illinois National Bank and Trust Company of Chicago	Continental Illinois Limited	United Kingdom

(continued)

United States Bank	Foreign Securities Firm	Market
The First National Bank of Boston	Boston Australia Limited	Australia
The First National Bank of Chicago	First Chicago Hong Kong Limited	Hong Kong
The First National Bank of Chicago	First Chicago Limited	United Kingdom
First Interstate Bank California	First Interstate Capital Markets, Ltd.	United Kingdom
Irving Trust Company	Irving Trust International Limited	United Kingdom
Manufacturers Hanover Trust Company	Manufacturers Hanover Asia, Ltd.	Hong Kong
Manufacturers Hanover Trust Company	Manufacturers Hanover Australia Limited	Australia
Manufacturers Hanover Trust Company	Manufacturers Hanover Limited	United Kingdom
Maryland National Bank	Maryland Bank International, SA	Luxembourg
Morgan Guaranty Trust Company	J.P. Morgan (Australia) Limited	Australia
Morgan Guaranty Trust Company	Morgan Guaranty Limited	United Kingdom
Morgan Guaranty Trust Company	Morgan Guaranty (Switzerland) Ltd.	Switzerland
Morgan Guaranty Trust Company	Morgan Guaranty Pacific Limited	Singapore
North Carolina National Bank	Carolina Bank Limited	United Kingdom
Republic National Bank of N.Y.	Republic NB N.Y. (Singapore) Ltd.	Singapore
Riggs National Bank	Riggs - U. K. London Limited	United Kingdom
Security Pacific National Bank	Security Pacific Australia Ltd.	Australia
Security Pacific National Bank	Security Pacific Bank (Asia) Ltd.	Singapore
Security Pacific National Bank	Security Pacific Holings Limited	United Kingdom
Wells Fargo Bank, NA	Wells Fargo Limited	United Kingdom

Source: Board of Governors Federal Reserve System

TABLE 6

SAFEGUARDS AGAINST CONFLICTS OF INTEREST AND UNFAIR PRACTICES

1. Extensions of Credit to an Affiliate - Section 23A

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) regulates extensions of credit and similar transactions between FDIC insured banks and their affiliates. Under this section an insured bank may not make a loan to an affiliate, purchase securities issued by an affiliate, or purchase any of the assets of an affiliate in an amount greater than 10 percent of the bank's capital and surplus. Further, the total of all such transactions between a bank and all of its affiliates is limited to 20 percent of the banks's capital and surplus. In all cases, the transaction must be on terms and conditions that are consistent with safe and sound banking practices. Any transaction with a third party is deemed to be a transaction with an affiliate to the extent that the proceeds are used for the benefit of, or transferred to an affiliate. Every extension of credit to an affiliate must be fully secured. A bank may not purchase a low quality asset from an affiliate unless, pursuant to an independent credit evaluation, it committed itself to purchase such asset prior to the time it was acquired by the affiliate.

The Federal Reserve Board may exempt transactions from the requirements of this section if such action is found to be in the public interest.

2. Transactions with Affiliates - Section 23B

Under the Competitive Equality Banking Act, a new Section 23B was added to the Federal Reserve Act, which places additional limitations on transactions between an FDIC insured bank and its affiliates, and covers a wider range of transactions.

In addition to extensions of credit and the other transactions covered by Section 23A, this section also applies to the sale of securities by the bank or its subsidiary to an affiliated company, the payment of money or the furnishing of services to an affiliated company, and any transaction in which the affiliate acts as an agent or broker. Further, any transaction with a third party is considered to be a transaction with an affiliate if the affiliate has an interest in or is a participant in the transaction, or if any of the proceeds of the transaction are used for the benefit of or transferred to an affiliate.

Under Section 23B, all of the transactions described above between a bank and an affiliate must be on an "arms length" basis; that is under terms and conditions substantially the same as those prevailing in the marketplace. In addition, a bank may not purchase any security during the underwriting period if a principal underwriter of that security is an affiliated company unless such purchase is specifically approved by a majority of the bank's directors who are not officers or employees of the bank. A bank may not purchase as a fiduciary any securities or assets of an affiliate unless specifically authorized by the trust agreement, court order, or other law governing the fiduciary relationship. Finally, a bank may not publish any advertisement or enter into any agreement stating or suggesting that the bank shall be responsible for the obligations of an affiliate. The Federal Reserve may exempt certain transactions from the requirements of this section if such exemption is found to be in the public interest.

3. Purchase of Securities From Directors

Section 22(d) of the Federal Reserve Act (12 U.S.C. 375) provides that a member bank may not purchase from any of its directors any securities or other property unless such purchase is made in the regular course of business and on an "arms length" basis, or when such purchase is approved by a majority of the bank's board of directors. Similarly, a member bank may only sell securities or other property to a director is such sale is on an arms length basis and in the regular course of business.

4. Loans to Officers, Directors and Major Shareholders

Section 22(g) and (h) of the Federal Reserve Act (12 U.S.C. 375a-b) regulates extensions of credit by an FDIC insured bank to officers, directors and major shareholders of that institution. A major shareholder is defined as any person or group of persons with the power to vote 10 percent or more of any class of the bank's voting securities. These restrictions also apply to extensions of credit to an officer, director or major shareholder of an affiliated company or a parent bank holding company, or a company controlled by such persons, or to a political action committee controlled by or established for the benefit of such persons. Such loans may only be made on an "arms length" basis, and may not involve more than the normal risk of repayment. Various approvals and restrictions are placed on the amount and purposes for which these loans may be made.

Extensions of credit made to officers, directors and major shareholders of correspondent banks are similarly regulated. (12 U.S.C. 1972)

5. Anti-Tying Provisions

The Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1971 et. seq.) generally provide that a bank may not furnish any service or change the cost of any service, on the condition that a customer obtain some additional service from that bank or the parent holding company or subsidiary thereof, or provide an additional credit, property or service to the bank or holding company. An exception is made to permit a bank to require that the customer obtain an additional loan, discount, deposit or trust service, and for additional conditions that related to and usually required in connection with the bank service in question, as well as conditions imposed by the bank to assure the soundness of the credit.

For purposes of these restrictions, a "bank" is defined in the same manner as under the Bank Holding Company Act, which now includes FDIC insured banks.

6. Restrictions on Dividends

National banks may not pay any dividends if its losses equal or exceed its undivided profits, after subtracting losses and bad debts. (12 U.S.C. 56). The approval of the Comptroller of the Currency is required before any dividends may be declared in excess of the institution's net profits for that year, combined with its retained net profits of the preceding two years (less any required transfers to surplus). (12 U.S.C. 60). Restrictions on dividends declared by state chartered banks may also be imposed under state laws.

7. Management Interlocks

The Depository Institution Management Interlocks Act (12 U.S.C. 3201 et. seq.) generally provides that a management official of a depository institution or holding company may not serve as a management official with another depository institution or holding company not affiliated with the first institution, if an office of both institutions are located within the same metropolitan area. However, a management official of an institution with $1 billion or more in assets may not serve as a management official in any other nonaffiliated depository institution with assets of $ 500 million or more.

8. Securities Disclosure Requirements

Pursuant to section 12(i) of the Securities and Exchange Act of 1934 (15 U.S.C. 78l(i)), FDIC insured banks are exempt from the registration requirements of that Act with respect to their own securities. However, the federal bank regulatory agencies are directed by that statutory provision to promulgate regulations which are substantially similar to the regulations issued by the SEC. Thus, banks with 500 or more shareholders and at least $ 1 million in assets are required to file registration statements and periodic reports, issue proxy statements and make other public disclosures is a similar manner as other publicly held corporations. (See, e.g. 12 C.F.R. pt. 206).

9. Anti-Fraud Provisions

Banks are not exempt from the anti-fraud provisions of the Securities Act of 1933 or the Securities and Exchange Act of 1934. Under these laws it is unlawful to employ any device, scheme or artifice to defraud or to make any untrue statement of a material fact, or to omit to make a statement necessary to make a statement already made not misleading, or to engage in any other act or practice or course of business which would operate as a fraud on a person in connection with the purchase or sale of any security. (See, e.g. 17 C.F.R. 240.10b-5). Under these provisions, for example, it has been held that a bank cannot take actions which have the effect of manipulating the market for a security, and cannot trade based on inside information.

10. Capital Adequacy

The federal bank regulatory agencies determine minimum capital ratios through administrative actions. In general, the bank agencies have set the minimum ratio of total capital to adjusted total assets at 6%. The agencies have the authority to establish higher capital ratios as may be necessary, either on an individual basis or through general regulations. Thus, for example, a newly chartered bank, a bank receiving special supervisory attention, or a bank having a high proportion of off-balance sheet risks (such as standby letters of credit) may be required to have a higher capital ratio. In addition, under the International Lending Supervision Act (12 U.S.C. 3907), a banking agency may issue a directive to a particular institution requiring that institution to establish a plan to increase its capital.

11. Authority to Examine Affiliates

Under the Bank Holding Company Act (12 U.S.C. 1844), the Federal Reserve Board is authorized to conduct examinations of all subsidiaries of a holding company, including the nonbanking subsidiaries. In addition, under the Federal Reserve Act (12 U.S.C. 338), the Board may examine all affiliates of a state member bank. Similar authority is granted to the FDIC with respect to affiliates of insured banks (12 U.S.C. 1820(b)), and the Comptroller of the Currency, with respect to national banks (12 U.S.C. 481).

12. Bank Loans Used to Purchase Securities From Affiliates

Section 7 of the Securities and Exchange Act (15 U.S.C. 78g) authorizes the Federal Reserve Board to promulgate regulations governing the amount of credit which may be used to finance the purchase of any security. Board regulations under this authority currently limit the maximum loan value of any margin stock (securities listed on any national exchange or issued by an investment company), except options, at 50 percent of current market value.

(12 C.F.R. 221.8.) Section 11(d) of the Securities and Exchange Act (15 U.S.C. 78j) prohibits a securities firm from arranging for an extension of credit to or for a customer on any security which was part of a new issue the securities firm participated in the distribution of within the past 30 days. In addition, both sections 23A and 23B of the Federal Reserve Act cover loans made to third parties which are used for the benefit of an affiliate, and thus would appear to include extensions of credit used to purchase securities from an affiliate.

13. Conversion of Bad Bank Loans Into Bond Issues

The disclosure requirements of the Securities Act of 1933 (15 U.S.C. 77g,77j & 77aa) require detailed disclosure concerning the financial condition of the issuer and the intended use of the proceeds from the offering. The anti-fraud provisions, as noted above, require the inclusion of statements necessary to make a statement previously made not misleading. These requirements make it highly unlikely that a bank could package bad loans into securities to be distributed to the public, without disclosing the quality of the collateral backing the securities.

eral Reserve last week when he was here, about that issue and whether or not the move to give banks new securities products and perhaps other powers was necessary because of declining profitability.

He argues quite strongly the other way, that there really is not a profitability problem there as he sees it that one could solve by new product lines. It's very interesting and I'll just quote a little bit of what he said.

> I think there are considerable financial problems in the banks, but at the moment we do not yet see conclusive evidence that underlying bank profitability per se has undergone significant erosion, meaning by that that we can account for most of the actual reported decline in bank profits by problems in quality of loans, by technical issues which are not long term.

He goes on to say that in the securitization area he does have a concern because there's been a change in the way we package and market those kinds of issues.

But to help me understand the difference between his view and yours, I understood you to say that you really need these new lines of business because your profitability is being eaten away.

Mr. STEVENS. That's right. Competition provides a downward pressure on the rates we charge for loans. It's been relentless. It also provides upward pressure on the interest we pay on deposits. Consequently, our net interest margin keeps eroding. It's off 35 percent for us during this decade.

Now in Charles Pistor's statement, exhibit 2 shows, contrary to what the Chairman was saying, a return on equity for nonenergy, nonfarm, non-LDC-related commercial banks—this is the return on equity for all commercial banks that are deemed to be healthy. As you can see, in 1978 ROE was above 12 percent; in 1986, it's about 9 percent.

If you look at banks more our size, zero to $300 million in assets, return on equity, was about 8 percent. So the return on equity, the ability to maintain our capital, is eroding. And that's my concern.

Senator RIEGLE. So you're clear then in arguing two things: No. 1, that there is a secular decline in bank profitability apart from the special problems; and No. 2, the way to solve the problem is with new lines of business? That's really your argument?

Mr. STEVENS. That's correct.

Senator RIEGLE. And the new lines of business that you feel you need to have are what precisely again?

Mr. STEVENS. Well, I speak for the Bryn Mawr Trust Co. and we would sure like to be in all three of the areas that have been talked about—insurance, real estate and securities. We believe there's opportunity in each of those for us to be able to increase our revenue stream which currently is so narrowly defined.

Senator RIEGLE. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Mr. Chairman, I had some other questions that I would like to ask, but to pursue the line of inquiry that Senator Riegle has just been on, in the last few days I've had an opportunity to talk to some of the people who have been through the recent history of the thrifts and to summarize their historical analysis it would be that thrifts had been a fairly simple financial institution highly regulated to operate. Then a decade or so ago, regulations began to fall in other areas which put them into a very difficult profit squeeze and suddenly they were in a situation of loaning long and borrowing short without regulatory protections. And this led to a call for the expansion of businesses in which they could be in and many States, including my own, Florida, extended substantial new powers to the thrifts. Many formerly federally chartered thrifts became State chartered in order to take advantage of those new powers.

And the consequence now is that they have in fact become involved in many new businesses, but since that has proven in many instances to have not been a very prudent set of business judgments, many thrifts are in even more severe financial problems now than they were when this process of change started.

If that is somewhat an accurate historic statement of the recent history of the thrift industry, what is it that causes you to believe that the commercial banking industry, if the only thing that is done is as it was in the thrift industry and that is respond by granting additional authorities to engage in new business activities, that you will not suffer a similar fate?

Mr. STEVENS. The thrift industry it seems to me is a classic example of an industry trapped in a very narrow line of business. During the housing boom following World War II, thrifts found themselves with very long term fixed rate assets funded by short term liabilities. When interest rates rose, they experienced serious problems. Along with that came the effort to advance their lines of business. Then came a second crunch.

I'm not convinced that what's happened to the thrifts has happened because of the additional powers. There were some excesses in real estate. But it wasn't just the thrifts who got caught up in some of those excesses in real estate. And the trouble they're having doesn't come from the wider variety of powers that they have, but rather the same kind of problem with the same old business—bad loans.

The thrust of what we say is that we would like to be able to serve customers like Mrs. Phillips. I told the story about a little woman who came in to seek some advice from us which we're perfectly capable of giving but may not because of the restrictions of the law—investment advice. We ought to be able to do that for a wider variety of audience than we can now. That would help us. That would help us a lot.

Senator GRAHAM. I guess what concerns me is that there seems to be a haunting parallel between what happened a few years ago with the thrifts and what's now being suggested with the commercial banks. That is, we have a problem because our traditional business areas are limited and are being squeezed through new competitors; therefore, the prescription to this malady is to give us additional powers so that we can get into new business fields which will sustain our profitability.

I think there's a persuasive case that in a number of instances in the area of the thrift industry you had people who were not particularly well equipped to get involved in these new areas and that by treating the illness singularly through an extension of additional powers that what we essentially did was privatize the profits for those firms that were able to do well and it socialized the losses through the insurance system for those who didn't do well, and now we are going to be picking up the pieces of that unfortunate prescription.

My question is, give me some confidence that if the only thing we do is reform Glass-Steagall that we will not be repeating that history.

Mr. **Crutchfield**. Sir, if I can, as a banker in your State, respond to that. I'm no expert on the thrift industry, but I think that perhaps what we have is an overregulated industry in the sense that its traditional menu of products and services was very restricted, while on the other hand, there is perhaps not enough regulation of its more recent activities.

I think that the firewalls contemplated in this bill address that issue head-on.

Second, I would say that the banks have already been in closely related businesses to the kinds of businesses contemplated in Glass-Steagall. For example, we have about a $7 billion Government bond portfolio. We trade billions of dollars of Government bonds every day. I could step out to the telephone here and in 2 or 3 minutes buy $1 billion worth of Government securities. If the market moved a fraction, I would lose $10 million or gain $10 million in value probably by 5 p.m. So it's not like these "children" in the banking industry can't be trusted to handle this exotic investment banking kind of stuff. That's just bunk.

We couldn't underwrite a $10 million revenue bond issue, but we can lose $10 million in 15 minutes on underwriting Government issues where we already have a long history of success.

Senator **Graham**. Thank you.

Mr. **Stevens**. If I could, I would like to add one comment to that. In suburban Philadelphia, we have a very healthy savings and loan industry and one of our prime competitors is a S&L which has taken great advantage of the new powers and done a very nice job, both for themselves and for the community. So it's not universal that new powers have caused problems. It's caused problems in some places, but not in all.

The **Chairman**. Gentlemen, before I call on Senator Garn, let me thank you very, very much for your excellent testimony. I have no further questions and I know the other panel is very anxious to come on and you also have planes to catch. I think your testimony has been excellent and your responses to the questions I think have been very enlightening and helpful.

Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman. I have no additional questions, but in response to the comments of Senator Graham, I think you'd be interested that the scenario that you outlined has been presented to this committee on numerous occasions over a period of several years. I distinctly remember one panel of witnesses when we were considering my 1984 bill 3 years ago. The panel was going on at great length about how could we be stupid enough to even consider additional powers for banks because of what additional powers had supposedly done to the thrift industry.

I challenged that group of witnesses to give me one example—one—of one institution in this country where they could attribute the failure to additional powers. And when they could not, I said, "Well, I realize that hits you cold and you don't have specifics to back up your testimony. Please feel free to submit an answer in writing." I never heard from them. That happened over and over again because I think if you go to the regulators and you examine the failures and get into the details of the thrift problems you will find that they got into trouble primarily because of the activities that they have always been engaged in. It was their interest rate match problem, borrow short and lend long, and the fact that they made some incredibly bad mortgage loans. But most of the failures, virtually all, came about as a result of the powers that they had always been able to engage in or some good old-fashioned fraud, abuse, dishonesty, and or cheating.

So I believe the record is very, very clear that they failed because of their traditional lines of business and not because of additional powers.

On the other hand, we can show you many troubled thrifts that intelligently took advantage of additional powers and have thrived and are making record profits. So I hope we can get back to looking at the real world of what has taken place. But certainly, Senator Graham, that is something that has been said many, many times by many, many witnesses before this committee who simply have not been able to put the cause and effect together.

Thank you very much, gentlemen.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you very much, Mr. Chairman. I will try to be very brief here.

If in order to get into the securities business full-blown—securities and anything else that you would like to do—insurance, real estate, and perhaps even go across the line into commerce generally—and some banks want to do that and certainly commercial firms, many, want to come into banking.

FEDERAL DEPOSIT INSURANCE

If in order to do that, to have a really wide open, full-blown playing field like that, you had to give up Federal deposit insurance, would you be prepared to do it?

Mr. CRUTCHFIELD. Speaking for myself, yes, sir.

Senator RIEGLE. You would give up Federal deposit insurance?

Mr. CRUTCHFIELD. Yes, sir. My feeling is that if you run a bank so poorly that you're going to have to call on the Federal deposit insurance, you've got problems that go way beyond the scope of anything we're talking about this morning.

Senator RIEGLE. Mr. Stevens?

Mr. STEVENS. As an individual, I have no problems with that. It seems to me, as a public policy concern, you've got a lot of folks out there who might be very much unsettled if you just dropped that back. An alternative would be to cut back that coverage.

Mr. CRUTCHFIELD. I should add I'm speaking for myself and not the American Bankers Association on that.

Mr. STEVENS. I would like to say the same thing.

Senator RIEGLE. Well, you're part of it, though, and it's interesting to get your view on it. I assume you feel that in terms—obviously, there's probably no way to break the connections as a practical matter with the Federal Reserve System—of the creation of reserves and the payments system. That has to be maintained.

But I find your answer interesting with respect to the FDIC.

Mr. CRUTCHFIELD. Sir, could I just add to that answer by saying that the protections contemplated in the bill obviate any need to reduced Federal deposit insurance.

Senator RIEGLE. Now I want to just press the profitability issue again. There's a depressing article in today's financial pages on the question of bank profitability for the third quarter and a lot of the erosion of bank profits has to do with Third World loans.

THIRD WORLD LOANS

Do either of you make Third World loans? Are you under water in any significant way? I know a number of banks are. You may or may not be.

Mr. CRUTCHFIELD. We have a few, yes, sir. We are a $25 billion asset bank. We have $50 million to the Third World.

Mr. STEVENS. We have none, Senator.

Senator RIEGLE. I take it, though, that when that line of business, that opportunity, opened up, I assume that looked pretty good at the time. I mean obviously you didn't go into those loans to lose money. You went into them to make money. But that turned sour. It seems to have generally turned sour for most people that have made a lot of the Third World loans.

Why wouldn't that experience cause you to think that maybe something that may look terribly promising in a new line of business in fact might not turn out that way? I notice, for example, that we're seeing a lot of shrinkage right now in municipal bond activity. We're seeing investment houses getting out of it. We're even seeing banks scaling down in that area.

I can see why you would want more things to do, but the degree to which you have confidence that you can make money in those new lines of business is a lot harder for me to see and I'm not sure I've heard a convincing argument as to where that profit is out there that you're going to be able to go and get that in effect is going to shore up this sort of profit erosion problem.

Mr. CRUTCHFIELD. Your implication is that all that glitters is not gold, and we ought to recognize it. Again, speaking for myself, I don't think that the reform contemplated in the Proxmire-Garn bill is a panacea for bank holding company profitability. I don't think it is. That industry is not the most profitable business in the world either.

But it does seem, nevertheless, an unnecessary complication to have to stop at the border and not be able to serve our customers. I think we can make some money in the securities business. It's fee income business mostly, and it just seems unnecessary to be held out of it. I'm not here to say to you that it will solve or cure the problems of the banking industry by itself. I don't think it will.

Senator RIEGLE. Let me just as finally, on the question of the ultimate combination of banking financial services and commercial activity generally—the automobile companies becoming bankers at the same time or any other commercial firm, G.E., what have you—are you fellows prepared to accept that proposition?

Mr. **Stevens**. It's a wide leap from where we are now, and I'm afraid I'm not enough of an expert to be able to understand exactly how far we should go.

The reality of the world is that Ford Motor Co. owns a large across-the-Nation savings and loan association. So in reality, from a customer's viewpoint, it's going on now. Maybe there are some ways to combine banking and commercial activities that would make everybody comfortable.

Senator **Riegle**. Mr. Crutchfield, do you have a comment?

Mr. **Crutchfield**. Yes, I do have a comment. We have watched Senator Proxmire and Senator Garn try to pass legislation for years. We need specific help in the area contemplated by this bill. If broader, more global and far-reaching kinds of things like commerce and finance happen to pass, that would be fine. We want them. We would be for it, and I personally would have no big problem with that. But I hope we don't get sidetracked on trying to solve all that in lieu of addressing some more narrow issues.

Senator **Riegle**. Thank you, Mr. Chairman.

The **Chairman**. Senator Graham.

Senator **Graham**. No further questions.

The **Chairman**. Thank you very, very much, gentlemen. We appreciate your testimony. As I said, I think it has been very, very helpful to us.

Our next panel consists of Edward O'Brien, president, Securities Industry Association of New York; John Bachmann, chairman of the board, Securities Industry Association, also of New York City; and David Silver, president of the Investment Company Institute.

Senator Garn has an opening statement. Go right ahead, Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **Garn**. Thank you very much, Mr. Chairman.

Today's testimony focuses on the usual suspects in this game, both the banking and the securities industries.

Before I make my comments, I would like particularly Mr. O'Brien and Mr. Silver to know that in no case are my remarks personal in any way. Each has been too good a friend for too many years and I have too much respect for them to think that they would take my remarks personally. But they also know how strongly I have tried over 9 years to talk about a two-way street and have always made the comment that there were two ways to solve the problem—either the securities firms had to get out of the banking business or banks had to be allowed in the securities business, one way or the other. Either way would be fair.

Unfortunately, to put the genie back in the bottle is probably impossible.

Let me make a couple of comments about the testimony of the SIA today. The first concerns the moratorium. The prepared SIA statement takes great pains to avoid using that word by employing several euphemisms instead of the word "moratorium." But the intent is crystal clear: Congress should extend the moratorium while it adds another endless study to the tens of thousands of pages that we already have on this subject. In case anybody has been out of town the last few months let me say again that I will do everything I can to see that the moratoriums are not extended.

Second, the testimony goes on at great length about the failure of the Proxmire-Garn and Wirth-Graham bills in not going far enough to create a two-way street. I would agree with that criticism.

I would admit that neither of these bills goes as far as I would like to in that area and I'm hoping that through the process we can change that, because there are some firms that in order to participate in banking would have to give up other activities.

It seems to me that what the SIA wants is not a two-way street, but to have it both ways.

They want to get banks out of the securities business, but never acknowledge the encroachment of securities firms into banking through nonbank banks, cash management accounts, third party checking and bridge loans.

They want to blame the banks for causing the stock market crash in 1929, but use the recent dive that did not involve banks as an excuse to keep them out.

They urge Congress to by all means do something, some day, but in the meantime to do nothing by extending the moratorium.

They focus on bank conflicts of interest, but say nothing about the same conflicts that arise in the securities industry through ownership of nonbank banks and much more active lending, let alone the conflicts that have led to the insider trading scandals.

They argue about bank concentration of resources, but fail to mention that the largest financial firms in this country are not bank holding companies but diversified companies that own the largest securities firms.

My point is simple. Like it or not, banks and securities firms are already in each other's backyards. That is the reality of the marketplace.

We need to pass legislation that recognizes this reality and regulates it properly. That is what each of these bills before us is attempting to do and I hope through the process that we can make enough modifications that we do achieve a really two-way street that is fair and pass legislation so that we don't have to worry about moratoriums.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very, very much.

I guess we will proceed in alphabetical order here, Mr. Bachmann, unless you gentlemen would prefer another order, whatever you wish to do. Mr. Silver, would you like to start?

Mr. SILVER. Yes, if I may. I have a personal matter to attend to.

The CHAIRMAN. Of course.

Mr. SILVER. I would also like to say that Matthew Fink, my colleague, is here and I will take the easy part of reading the statement and letting him answer your searching questions today if I must leave.

The CHAIRMAN. Well, we're going to miss you. You've given very good counsel to the committee.

Senator GARN. He's a good photographer, too.

Mr. SILVER. Not as good as you are, Senator.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE, ACCOMPANIED BY JOHN DOWNEY, VICE CHAIRMAN, SIA; AND MATTHEW P. FINK, GENERAL COUNSEL, ICI

Mr. SILVER. When I last appeared before this committee representing mutual funds earlier this year I discussed the cluster of circumstances which persuaded the Congress in 1927 to permit comercial banks to enter the securities business—apparently ebullient stock markets achieving new daily highs, depressed profits in traditional banking particularly in agricultural States, a belief that modern times in the form of financial supermarkets made sense by bringing efficiency to the public as well as profits to the banks, and finally a belief that the regulatory structure of the day was adequate to handle any problems. Indeed, one journal in 1927 ecstatically noted that securities regulation might even be improved as the Comptroller was virtually being given the authority to write a national Blue Sky law.

And then came October 1929 and the months and years that followed. Rarely does a legislative decision come back to haunt its framers in so short a time.

But with all due respect, I suggest that this Congress is being pushed by the banking industry to do its 1927 predecessor one better. You have concrete evidence of the bad news even before legislating. I am not only referring to the events of this past October 19. The warning flags have been flying. To mention just a few, I refer to bank REIT's in the mid-1970's, the Drysdale fiasco, Bank of America's misadventures in securitized mortgages in the mid-1980's, and finally the latest mania of mixing together FDIC-insured CD's with equities through the massive use of those tried and true bulwarks of safety—financial futures.

I would go further and suggest that although the Congress has been on notice of these misfortunes, until now there has never been a serious attempt to plumb their depths in order to determine what shoals lie beneath the warning flags to see how these events bear on Glass-Steagall issues. Once you pierce the administrative iron curtain and ascertain the true facts of these events, you may well find systemic shortcomings in the same regulatory structure on which the post Glass-Steagall era will so heavily rely.

I would also ask the committee's indulgence to further depart from our own written statement to offer a few personal thoughts on the relevance to these hearings of the 1929 experience, as compared to the 1927 expectations, and how, in light of the trauma of October 19, 1987, the dangers of the 1920's live on. In that context, you will more clearly understand our reservations about the bills before you.

BANKS WANT TO MARKET MUTUAL FUNDS

We should start with the recognition that the banks have made it abundantly clear that they wish to mass-market mutual funds and other equities to their own safety conscious depositors. This is why the banks seek to capitalize on the bank's name, and this is why they have strenuously opposed proposals to prohibit the use of the bank's name by their proposed securities affiliates and why they oppose with equal vigor proposals to prohibit cross-marketing. Thus, the first point to keep in mind is that the prime marketing target of the banks' securities affiliates will be the banks' customers—those millions of Americans who have opted for the safety of FDIC-insured accounts rather than accept the inherent risks of the securities markets. And experience tells us that this is the case.

As soon as Congress conferred the power on the banking industry to distribute securities in 1927, bank securities affiliates embarked on a binge of mass-marketing equities and shares of their own mutual funds to their normally risk-averse depositors. In the words of the counsel to this committee in 1933, this group of customers "were more than ordinarily gullible—because these salesmen came to them clothed with all the authority and prestige of the magic name of" the bank.

As one authority tells us, the identification with the bank was a major reason why bank securities affiliates "were able to sell such a large volume of securities during the twenties." When the 1929 crash occurred, these investors lost confidence not only in the stock market and the bank securities affiliates, but in the banks themselves.

By 1932 the negative identification of banks with the stock market was so great that in 1932 a major New York bank found it worthwhile to run an advertisement, which I have here, in the New York Times for Wednesday, February 22, 1932, disclaiming and disowning the fact that it ever engaged in the securities business and touted to the public that it was a good place to deposit money because it sold no securities.

There was ample evidence of bank securities abuses uncovered in the post-mortem of the 1920's to justify the enactment of Glass-Steagall. However, the scales were probably decisively tipped by the realization that the banks had abused their position of trust and confidence by drawing a multitude of smaller bank depositors into the market, thus adding to the superheated atmosphere of speculation which preceded the 1929 crash. When the bubble burst, the public had not only lost its money but its confidence in the fundamental integrity of the banking system. Glass-Steagall put an end to the marketing activities of bank securities affiliates which had successfully blurred the critical line between saving and investing and between safety and risk.

In recent years, revisionist economic history has been employed by the banking industry in its efforts to repeal Glass-Steagall. It has been argued that Glass-Steagall was an accident based on the misapprehension that bank securities activities "caused" the depression. But this misses the mark. As I have just pointed out, Congress never purported to find that banks had "caused" the depression. What Congress did find were demonstrated abuse coupled with the inherent misrepresentation that bank securities activities carried less risk because of the trappings of bank stability, followed by a massive loss of public confidence when it proved possible to lose as much money through bank securities affiliates as elsewhere. It was to prevent the recurring abuses and restore confidence that Congress enacted Glass-Steagall. And for 50 years Glass-Steagall has worked—the abuses are gone and public confidence in the banking system has been maintained.

On the other hand, one may speculate as to what the present legislative agenda would be today if in 1980 or 1982 the banks had succeeded in repealing Glass-Steagall and their securities affiliates had once again introduced 5 or 10 or 15 million risk-averse savers into the equity markets. I would venture to predict that in the wake of October 19, you would be considering far different legislation than the bills pending before you today. But, because you resisted that temptation, banks were essentially insulated from the events of October 19, and have not suffered the large losses of the securities industry. It flirts with danger that on the heels of this narrow escape you are seriously considering proposals to tear down the walls that probably prevented a debacle of large proportions. When the banks and the proponents of restructuring talk about loopholes and swiss cheese in Glass-Steagall they are trying to divert you from the clear evidence that the main line of Glass-Steagall has held and did its job very well indeed.

Should you nonetheless decide to go forward with the renewal of this failed experiment, it is clear that there must be the most stringent safeguards based on the experience of the past. Regrettably, the bills before you in one degree or another fail the test of history.

SHORTCOMINGS OF S. 1886

While S. 1886 purports to be comprehensive, it suffers from the same defects as some of its predecessors. It does not safeguard the interests of investors. First, as SEC Chairman Ruder testified, the bill fails to subject existing bank securities activities to regulation under the securities laws. Second, as the SEC also testified, the bill would authorize banks to enter into all aspects of the securities business without amending the securities laws to address the conflicts of interest that would result, conflicts which lay at the heart of so many of the past abuses—from the syndication of the Peruvian debt—yes, there was Third World debt in the 1920's—to the scandals of the REIT's in the 1970's.

Third, while the bill would authorize the creation of integrated bank-securities firm conglomerates, it does not provide for a corresponding integrated regulatory system. Instead, the activities of each entity in the conglomerate would be regulated by a different agency, without even establishing any mechanism for coordinating their activities or the sharing of information.

Prior experience indicates that fragmented regulation produces major gaps in public protection. The recent problems involving the options subsidiary of Continental Illinois Bank resulted from fragmentation between two banking agencies and this in turn produced one of the abuses which led to the enactment of Glass-Steagall—the improper use of bank assets to rescue a troubled affiliate.

I see, Mr. Chairman, that my time is up. I do have a few paragraphs on the other two bills. I do think that those bills, if you do move forward along this track, should be amended to provide the kind of stringent protections that Chairman Ruder has recommended and, in addition, and more importantly, there must be integration of the regulatory efforts.

If a major excuse for this bill is that there are being developed integrated financial services and an integrated financial industry, it makes no sense to have these services separately regulated under the jurisdictions of agencies which were created along the original functional lines which you will find, if you proceed on this legislative line, are obsolete.

I thank you.

[The complete prepared statement of David Silver follows:]

WRITTEN STATEMENT OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE
SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
ON S.1886, S.1891 AND S.1905
DECEMBER 8, 1987

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I am David Silver, president of the Investment Company Institute. The Institute is the national association of the American investment company industry. Its membership includes 2,363 open-end investment companies ("mutual funds"), 53 closed-end investment companies and 17 sponsors of unit investment trusts. Its investment company members have assets of about $926 billion, accounting for approximately 90% of total industry assets, and have over 29 million shareholders.

I. INTRODUCTION

The Institute appreciates the opportunity to testify before you on S.1886, the Financial Modernization Act of 1987, S.1891, the Financial Services Oversight Act (also known as the "Wirth-Graham Proposal"), and S.1905, the Depository Institution Affiliation Act (also known as the "Cranston-D'Amato Proposal"). Each of these bills is designed to restructure the financial services industry and would repeal the separation between commercial banking and investment banking that is embodied in the Glass-Steagall Act.

The Institute believes that the case for repeal of the Glass-Steagall Act has not been made, and that the continued need for the Act's prophylactic safeguards was demonstrated in October during the record stock market decline. We also believe that any legislation which would repeal or substantially modify the Act must accommodate historic national policies. Specifically, any new legislation must: prevent the abuses that inevitably arise from the combination of commercial and investment banking; insure the safety and soundness of the banking system; and provide for a fair field of competition.

Prior legislative proposals, however, have failed to address these issues, and have instead taken a piecemeal approach that focused solely on the expansion of bank powers. These proposals also have failed to recognize that the Glass-Steagall Act is merely one of many interrelated statutes governing the structure and functions of our nation's financial institutions. Therefore, the Glass-Steagall Act cannot be repealed or substantially modified unless parallel modifications are made to these companion statutes.

While the Institute has criticized prior legislative proposals, we have not sought to play a negative role in the debate concerning the possible restructuring of our financial system. Indeed, we have offered a comprehensive framework for legislative change, should Congress determine to repeal or substantially modify the Glass-Steagall Act. We are pleased that our proposals for comprehensive change, involving amendments to ten relevent federal statutes, have received favorable comment from agency officials, members of Congress and representatives of the banking industry.

While S.1886 purports to be comprehensive, it still suffers from the same narrow, piecemeal approach to financial restructuring as its predecessors. For example, the bill, like prior bills considered by this Committee:

-- fails to create an appropriate level of insulation between banks and their securities affiliates

-- fails to require the transfer of many bank securities activities to securities affiliates

-- fails to repeal existing exemptions for banks under the federal securities laws

-- fails to amend the federal securities laws to address the conflicts of interest that inevitably accompany the tandem operation of banks and securities affiliates

In his recent testimony before this Committee, SEC Chairman Ruder recommended that the bill be amended to address these last three problem areas. In 1983, the Institute submitted specific amendments in all three areas to the Department of the Treasury in connection with proposed legislation which would have amended the Glass-Steagall Act to authorize bank securities affiliates to sponsor and underwrite mutual funds.*

Inasmuch as we have discussed these problems and our proposed amendments in previous testimony before this Committee, we will not repeat our comments and suggestions today. Instead, we will concentrate on two of the other major defects of S.1886: first, the failure to create an adequate regulatory system to govern the activities of the proposed new integrated bank-securities firm conglomerates; and second, the failure to create a fair field of competition. In the course of our testimony, we will offer suggestions designed to address these problems, as well as comment upon the Wirth-Graham and Cranston-D'Amato Proposals.

II. THE COMBINATION OF BANKING AND SECURITIES ACTIVITIES REQUIRES THE DEVELOPMENT OF A COMPREHENSIVE NEW SYSTEM OF REGULATION

A. The Fragmented Regulatory Approach of S.1886

S.1886 represents an attempt to repeal the prohibitionist approach taken by Glass-Steagall and to replace it with a system of regulatory controls, an approach which Congress rejected in 1933 when it enacted the Glass-Steagall Act.

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* A copy of our 1983 submission is attached as Exhibit A.

However, while S.1886 authorizes the creation of integrated bank-securities firm conglomerates, it does not provide for a corresponding integrated system of regulation. Instead, regulation of the activities conducted by various components in a bank-securities firm conglomerate would be regulated by different regulatory agencies, each having independent regulatory jurisdiction over a particular component. The Federal Reserve Board would regulate the holding company, a bank regulatory agency would regulate the bank subsidiary, and the Securities and Exchange Commission would regulate the securities subsidiary. The bill not only fails to establish a mechanism for coordinating the regulatory activities of the differing agencies, but fails even to require that they share information with one another.

This type of fragmented regulatory structure is not adequate to cope with the problems that will arise from the operation of bank-securities firm conglomerates. Prior experience with a system of fragmented regulation indicates that such an approach is likely to produce major gaps in public protections. Each regulatory authority will myopically regulate the particular activity within its jurisdiction, in accordance with its own parochial regulatory mandate and abusive practices will flourish in these regulatory gaps. Indeed, by fragmenting responsibility among various regulatory agencies, S.1886 is likely to engender the very abuses which the Glass-Steagall Act was designed to prevent.

B. Fragmented Regulation Leads to Abuse

A number of recent examples illustrate this point. When the stock market fell dramatically in October, First Options of Chicago Inc., a subsidiary of Continental Illinois Bank & Trust Company, N.A., suffered enormous losses, and needed an infusion of cash in order to avoid insolvency. In the midst of this crisis, however, the various regulatory agencies failed to respond in a coordinated fashion, and instead debated about which entity in the Continental Illinois family should provide the necessary capital to First Options. The Comptroller, the regulator of First Options' parent bank, suggested that the funds should come from the holding company, but the Federal Reserve Board, the holding company's regulator, took a different view of the situation.*

Faced with this regulatory buck-passing, Continental Illinois lent the necessary money to First Options directly from the parent bank, even though such loans were in excess of the legal limit under federal law. As a result, the Comptroller instituted enforcement proceedings against Continental Illinois.* Thus, the fragmentation of regulatory responsibilities gave rise to one of the major abuses which led to the enactment of Glass-Steagall -- the improper use of bank assets to rescue a troubled affiliate.

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* See When Regulators Fall Out, Barron's, Nov. 16, 1987, at 15.

Another recent example of a regulatory gap resulting from the combination of banking and securities activities occurred in the early 1970s, when the federal banking agencies determined to permit banking organizations to sponsor pooled investment vehicles invested in real estate, known as real estate investment trusts ("REITs"). The day-to-day operations of the REITs were subject to regulation by the various bank regulatory agencies but the distribution of the REITs' shares to the public was regulated by the SEC.

In practice, the operation of bank-sponsored REITs was riddled with major conflicts of interest. For example, a major bank motive in sponsoring a REIT was to "assure its customers a source of real estate funds" for high risk or otherwise unsuitable loans for the bank. Thus, the banks could use their affiliated REITs "to avoid the existing bank restrictions on land and development loans"** to their customers. The banks also could sell loans from their own portfolios to their affiliated REITs when they needed to increase their liquidity or free up money for other purposes. Although such transactions may have served the banks' interests, they exposed REIT shareholders to serious financial risks, since the bank had substantial incentives to tailor the transactions for its benefit.

The inability of any single regulator to police adequately transactions involving bank-sponsored REITs and affiliated banks had disastrous consequences for investors. On one side of the fence, the SEC lacked the power to prevent the banks in question from exploiting such conflicts of interest; on the other, the bank regulators evidenced no real interest in protecting REIT investors. REIT investors suffered the consequences of this splintered regulatory authority when the conflict-laden bank-sponsored REITs soon encountered economic difficulties and their share prices plummeted.

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* See First Options' Luster Was Tarnished in Hard Week at Futures Exchange, Am. Banker, Oct. 28, 1987, at 1. Similarly, Jake Butcher was able to exploit the lack of coordination among the various bank regulatory agencies and to harm the bank subsidiaries in the United American Group banking family by transferring worthless assets back and forth among the various separately-regulated banks. See Banks' Current Ills Resist Usual Cures, Regulators Discover, Wall St. J., Aug. 20, 1986, at 1.

** Schulkin, Real Estate Investment Trusts: A New Financial Intermediary, New England Economic Review, November/December 1970, at 6.

C. The Likely Consequences of S.1886

Bank proponents of S.1886 have expressed particular interest in securing the power to sponsor and underwrite mutual funds through securities affiliates. Under the provisions of S.1886, however, the conflicts of interest that characterized bank-sponsored mutual funds in the 1920s[*] would inevitably resurface as a result of the division of regulatory responsibility inherent in the bill's structure. Under the bill, the bank regulatory authorities would continue to regulate the bank's lending activities, while the SEC would regulate the investments made by the bank's affiliated mutual funds. But no mechanism is provided for the coordination of the activities of the two agencies, or even for the sharing of information.

In his recent testimony, SEC Chairman Ruder urged that the Glass-Steagall Act must not be repealed unless, among other things, a parallel amendment is made to the Investment Company Act of 1940 to address specifically the conflicts of interest arising from a bank's commercial lending activities and the investments made by its affiliated mutual funds. But, even if S.1886 effects such an amendment, the SEC will not have information regarding the bank's loan activities. Consequently, the SEC would be unable to determine whether the mutual fund had made an investment in order to assist a troubled borrower from the bank, to accommodate a good commercial customer of the bank or otherwise to further the bank's commercial interests.

Bank proponents of S.1886 have also expressed the desire to have bank securities affiliates securitize and underwrite loans held in the bank's portfolio. Such activities present major potential conflicts of interest. A bank that has a securities affiliate which can securitize and underwrite the bank's loans has an enormous incentive to use this distribution channel to dispose of low-quality loans. Moreover, in an effort to generate fee income from loan originations, a bank might lower its lending standards on the assumption that it will be able to sell such sub-standard loans to investors through its securities affiliate. Likewise, a bank might lower its lending standards in order to generate a sufficient quantity of loans to keep its securities affiliate's distribution channels fully occupied.

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[*] In the 1920s, major banks and bank affiliates sponsored mutual funds (then known as investment trusts) and mass-marketed the funds' shares to the public. The Congressional hearings which led to the enactment of Glass-Steagall and a major SEC study found widespread abuses in connection with bank-sponsored mutual funds, many of which stemmed precisely from the bank's role as a commercial lender. These included fund investment in debentures of a troubled company which was indirectly financed by the bank and fund investments to accommodate "good customers" of the bank. Indeed, such conflicts of interest involving bank-sponsored mutual funds were a major reason for the enactment of the Glass-Steagall Act.

In any of these situations, the federal securities laws would require disclosure to investors of the risky nature of the underlying loans. The bank's credit evaluation with respect to such loans, however, constitutes confidential customer information. Indeed, under the terms of S.1886, the bank would be prohibited from disclosing confidential information in its files about the quality of such loans to its securities affiliate unless it received the consent of each of the loan customers involved. It is thus unlikely that either the SEC or investors would learn the true nature of the underlying loans until a default was actually experienced.

Nor will protections be provided through the regulation of the bank by the appropriate federal banking agency. The banking agencies' regulatory mandate does not include investor protection. Instead, the various banking agencies are charged only with protecting the safety and soundness of their constituent banks. Thus, because the bank would have improved its balance sheet by disposing of sub-standard loans, the banking agency would have no reason to use its regulatory authority to stop a bank from using its securities affiliate to sell low-quality loans to investors.

The existence of an independent, third-party underwriter ordinarily would serve as a check on a bank's ability to dump sub-standard loans on unsuspecting investors through its securities affiliate.* But, when the underwriter and the issuer are controlled by the same holding company parent, the underwriter's independence is seriously compromised. As the SEC noted in its testimony:

> Securitization of assets by affiliated issuers and underwriters raises a potential conflict between the underwriter's obligation to use due diligence in examining the offering and its

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* As part of its due diligence in connection with a proposed securities offering, a third-party underwriter typically will insist on inspecting the issuer's loan files and will refuse to go through with the offering unless adequate disclosure of the quality of the underlying assets is made in the prospectus.

> desire to repay affiliates through a successful offering.[*]

When the bank is forbidden as a matter of law from disclosing confidential information to the underwriter because the underwriter is an affiliate, as S.1886 would do, this check on the quality and completeness of disclosure becomes virtually nonexistent. Thus, not only is the due diligence function thwarted, but the SEC's oversight ability is hampered as well, since this information would be unavailable to the SEC.

These examples indicate that the system of fragmented regulation contemplated by S.1886 will be inadequate, and indeed that it is likely to result in the very harm to investors that Glass-Steagall was intended to prevent.

Furthermore, a bifurcated system of regulation will be unable to cope with the development of hybrid financial products. For example, Chase Manhattan Corporation has introduced a product, the Chase Market Index Investment, which allegedly features "'the best characteristics of an indexed mutual fund and a bank C.D.'"[**] Just as in a mutual fund, the investors' potential investment return on the Chase product is tied to the performance of a particular group of stocks. But, in order to obtain the benefits of deposit insurance, the Chase product is structured as a certificate of deposit issued by Chase's subsidiary.

The hybrid nature of the Chase Market Index Investment has generated a great deal of confusion among the regulatory agencies. The FDIC, for example, has made conflicting statements as to whether the Chase product is an insurable deposit.[***]

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[*] Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, before the Senate Committee on Banking, Housing and Urban Affairs Concerning Repeal of the Glass-Steagall Act, S.1886 and S.1891, Dec. 3, 1987, p. 19.

[**] Chase to Offer Account Tied to S&P 500 Index, N.Y. Times, Mar. 19, 1987, at 8 (quoting Robert R. Douglass, Vice Chairman, Chase Manhattan Corporation).

[***] "'Our informal view,' said the FDIC's assistant general counsel, Roger Hood, 'is that we do not insure the portion of the interest linked to the S&P [500 index].'" Quinn, A Chance to Play the Stock Market Without Losing Your Principal, Wash. Post, May 18, 1987, at F1. In contrast, Chase's earliest promotional material proudly informed investors that "[y]our entire investment is FDIC-insured up to $100,000." Chase Manhattan Bank, N.A., Handbook on the Chase Market Index Investment.

And, the Commodity Futures Trading Commission has barred Wells Fargo Bank from selling a similar certificate of deposit on which the interest rate was tied to the price of gold on the theory that, by selling such certificates of deposit, Wells Fargo was in reality selling a commodity option not on an exchange in violation of the Commodity Exchange Act.[*]

None of the current regulatory agencies can adequately regulate such a hybrid financial product. The banking regulators have insufficient expertise to police the securities aspects of Chase's product, while the Securities and Exchange Commission cannot ensure that the bank's activities are conducted safely and soundly. As a result, none of the current regulatory agencies possesses the tools necessary to evaluate the product and the risk that it might pose to the deposit insurance system. This problem would only get worse under S.1886, as the confluence of banking and securities activities would cause the development of hybrid financial products to accelerate.

D. *Possible Solutions - The Wirth-Graham and Cranston-D'Amato Proposals*

One possible solution to the problem of fragmented regulatory responsibility would be the establishment of a single regulatory authority to oversee all major financial institutions and markets.[**] We realize, however, that such a major change in the existing regulatory structure would give rise to enormous practical problems as well as to inter-agency political turf battles. An alternative would be the creation of an inter-agency council with a mandate to coordinate examination and regulatory responsibilities. This inter-agency council could be given the power to ensure that overlapping regulatory policies were coordinated, and to make certain that no regulatory gaps develop.

In this connection, we note that both the Wirth-Graham Proposal and the Cranston-D'Amato Proposal would provide for the establishment of a new umbrella regulatory commission comprised of representatives of the various federal regulatory agencies. This type of commission could form the basis for the type of inter-agency council we have suggested.

The role of the new regulatory commission under each of these Proposals, however, is not yet fully-formed, and needs to be fleshed out in more detail. For example, while the Wirth-

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[*] *See*, *Wells Fargo Barred From Selling CDs Tied to Gold Price*, Am. Banker, Nov. 23, 1987, at 1.

[**] *See* Kaufman, *The Need for an Improved System of Financial Regulation* (1987).

Graham Proposal gives this commission regulatory authority over transactions between affiliates, it does not address abuses of the type detailed above that can arise in connection with transactions involving holding company affiliates and investors. Likewise, the Cranston-D'Amato Proposal would give the new commission authority to establish uniform supervisory standards, but not the power to prevent abusive transactions of the type discussed above. Furthermore, neither bill gives the commission guidance on how to coordinate the activities of the various regulatory agencies. Thus, while both bills take an important new step in recognizing the need for the creation of a overall regulatory coordinator, neither bill yet gives this new commission sufficient power to address the problems that will arise from the operation of unified financial services holding companies.

III. ANY NEW LEGISLATION SHOULD PROVIDE FOR A FAIR FIELD OF COMPETITION

A. S.1886 Would Create a One-Way Street

The Institute has criticized previous legislative proposals considered by this Committee since they would allow banking organizations to engage in the securities business without giving securities firms an equivalent opportunity to engage in the banking business. Under those proposals, all banks would have been permitted to engage in enumerated securities activities (i.e., the sponsorship and underwriting of mutual funds and the underwriting of revenue bonds, commercial paper and mortgage-backed securities). But the nation's largest securities firms would not have been allowed to enter the banking business, since they underwrite corporate stocks and bonds and Glass-Steagall's prohibitions against the combination of commercial banking and the underwriting of corporate securities would have remained in place. As a result, these prior legislative proposals would have created an unhealthy competitive one-way street.

Proponents of S.1886 maintain that, by completely repealing the Glass-Steagall Act, the bill would create a fair field of competition under which all banks could enter the securities business and all securities firms could enter the banking business. But, while S.1886 would repeal the Glass-Steagall Act, it would leave in place Section 4 of the Bank Holding Company Act, which prohibits a bank holding company and its subsidiaries from engaging in non-banking activities that are not deemed by the Federal Reserve Board to be "closely-related" to the banking business.

Most of the nation's large securities firms are affiliated with insurance, real estate or commercial firms which are engaged in activities which cannot satisfy this standard. Indeed, according to the American Banker, "all but a few of the top 30 investment banking firms" are engaged in activities that are impermissible under the Bank Holding Company Act.*

As a result, the vast majority of the nation's securities firms would continue to be precluded from engaging in the banking business, while all banks would be free to engage in the securities business. This is hardly a recipe for fair competition, a point which has been recognized by the Vice Chairman of Citicorp, who acknowledged in recent testimony that:

> [T]he repeal of Glass-Steagall would not address the problem of fairness to competitors who engage or desire to engage in activities that are otherwise impermissible under the Bank Holding Company Act.**

B. The Wirth-Graham Proposal Offers a Partial Solution

The Wirth-Graham Proposal offers a more balanced approach and would permit a financial holding company to engage in all types of financial services activities, including banking. However, under the Wirth-Graham Proposal, any company which controls an insured bank would be prohibited from engaging in any "commercial activity." Although the bill does not define the term "commercial activity,"*** many major securities firms likely would be precluded under the Wirth-Graham Proposal from engaging in banking activities since they have commercial affiliates.

C. The Cranston-D'Amato Proposal Would Create a Two-Way Street

The Cranston-D'Amato Proposal would permit any business, including a commercial firm, to engage through a holding company structure in all financial service activities, including banking. Thus, all banks could engage through affiliates in securities activities and all securities firms could engage through affiliates in banking activities. Thus it is the only one of the three bills which provides for a full-fledged two-way competitive street.

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* Proxmire Strives To Make History, Am. Banker, Nov. 9, 1987, at 9.

** Written Statement of Hans H. Angermueller, Vice Chairman, Citicorp/Citibank, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, at 4 (Oct. 14, 1987).

*** The Wirth-Graham Proposal delegates to the Financial Services Oversight Commission the authority to determine what activities constitute "financial services" and thus, by implication, what activities are deemed to be "commercial activities." See S.1891, Sections 103(a)(1), 109 & 201(b), 100th Cong., 1st Sess. (1987).

D. The McFadden Act and the Douglas Amendment Must Be Repealed

However, even complete repeal of Glass-Steagall and Section 4 of the Bank Holding Company Act, unless accompanied by legislation permitting unrestricted interstate banking, is likely to result in an unfair competitive situation.

The geographic restrictions on banking contained in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act have perpetuated a well-developed, nationwide correspondent system of banks through which the largest banks distribute their products and services through smaller "country banks":

> Correspondent relationships with "country banks" provide [major banks] another captive market. Major banks offer their correspondents services such as check clearing, loan participations, lines of credit and investment advice in return for deposit balances. A natural allegiance to the respondents arises from this relationship . . . .*

If the Glass-Steagall Act is modified to permit large banks to engage in new securities activities, they can be expected to utilize the correspondent system to distribute securities through their well-established relationships with local banks. In each community, these securities activities will be linked to the banking services provided by local banks to their banking customers.

Thus, repeal of the Glass-Steagall Act will give the large banks a major competitive advantage over traditional securities firms. This advantage will exist even if securities firms are permitted to exercise full banking powers in a single state since, as new entrants into the banking business, securities firms would be newcomers to the correspondent system which had grown in the protectionist shelter of the McFadden Act and the Douglas Amendment. This competitive disadvantage can only be ameliorated by permitting securities firms to engage in all banking activities and to do so throughout the nation.

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* Mehle, Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition, 26 Syracuse L. Rev. 1117, 1145 (1975).

There is an inherently elusive logic in the proposition that a Wisconsin bank, a Michigan bank or a Utah bank should be able to offer a broad spectrum of banking and securities services, while the branch offices of regional and national securities firms down the block in the same city are barred from the banking business. If there is an economic calculus which says that this will lead to improved competition, it would seem to be a well-kept secret.

IV. CONCLUSION

Although S.1886 has been described by its proponents as a comprehensive bill, it in fact suffers from the same piecemeal approach as prior legislative proposals considered by this Committee. S.1886 would authorize the creation of integrated bank-securities firm conglomerates, but fails to protect investors since it does not establish an integrated system of regulation. Furthermore, S.1886 would permit all banks to enter the securities business, but would not permit most major securities firms to enter the banking business; it would also perpetuate anti-competitive geographic monopolies.

The Wirth-Graham and Cranston-D'Amato Proposals recognize the need to create an adequate regulatory system, but the concept of an umbrella regulatory authority has not yet been fully developed. As to the issue of fair competition, only the Cranston-D'Amato Proposal would provide a full two-way street. None of the bills would repeal the McFadden Act and the Douglas Amendment, and thus none address the issue of anti-competitive geographic monopolies.

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EXHIBIT A

August 26, 1983

DAVID SILVER
PRESIDENT

Honorable R. T. McNamar
The Deputy Secretary of the Treasury
Department of the Treasury
Washington, DC 20220

Dear Mr. McNamar:

On July 19, 1983 we met with you, members of your staff and representatives of other agencies to discuss the mutual fund industry's preliminary views with respect to the Treasury Department's proposed Financial Institutions Deregulation Act of 1983. At the meeting we reaffirmed our desire to work with the Department and the Congress in fashioning appropriate legislation dealing with the financial services industry. However, we emphasized our strong belief that any such legislation must provide adequate public protection, insure reasonable competitive equality among all segments of the financial services industry, and guard against excessive concentration of economic power. We stated that our preliminary analysis of the bill indicated that it failed to achieve these essential objectives.

Any legislation which would repeal or drastically modify the Glass-Steagall Act is a serious undertaking. Assuming that there is a consensus that a major shift in public policy is now desirable, any implementing legislation must be thoughtfully constructed to avoid, so far as possible, the mistakes of the 1920s which caused such enormous damage to the economic and social fabric of our country. The crucible of history demonstrates that market discipline has not provided a sufficient regulatory mechanism for the intense conflicts of interest inherent in the combination of the banking and securities industries. Palliatives such as separate affiliates and the application of the existing securities laws cannot be expected to provide adequate investor protection. During the 1920s, many banks conducted their securities operations in affiliates and this did not save the country from disaster. The current securities laws cannot cope with these special problems since those laws were written in the conscious belief that banks were generally excluded from the securities business.

Since our meeting we and our members have had some opportunity to analyze the bill in greater detail. We regret to state that this analysis has reinforced our preliminary views regarding the bill and that we must now register our strong opposition to its enactment.

The bill as now written would not deregulate the financial services industry, but would simply authorize a number of the nation's largest banking institutions to enter new areas of endeavor, while retaining all of their special advantages over non-bank competitors. Enactment of the bill would rapidly destroy the securities industry as an independent line of business and would increase the concentration of economic power in a few giant banks.

An even greater flaw is that the bill would permit banks to enter the mutual fund business without attempting to guard against the precise conflicts of interest which history demonstrates are inherent in the combination of commercial banking and securities activities. Moreover, the bill fails to carry out the Treasury Department's stated goal of requiring all existing bank securities activities to be transferred to separate affiliates and thus made subject to regulation under the federal securities laws. This bill also does nothing to settle the many issues currently in litigation regarding the proper scope of bank securities activities.

We are particularly disturbed at many of the deficiencies in the bill since expert witnesses at recent Congressional hearings, including SEC Chairman Shad and Federal Reserve Board Chairman Volcker, identified specific problem areas and urged that they be dealt with in any legislation. Further, at recent hearings before the Senate Banking Committee and its Securities Subcommittee, the Institute offered a number of statutory amendments to deal with these problems. We understand that many banks would not like them, but we regret that the Department of the Treasury has simply chosen to ignore them. For our part, we intend our suggestions seriously. They are based on 50 years of expertise in the investment business and, we believe, a sound reading of history.

At our meeting on July 19, you asked us to identify problem areas in the bill and to submit corrective amendments. We are attaching a memorandum discussing specific legislative language to deal with each of them. As noted, most of the amendments have previously been endorsed by the Institute while others have not yet been approved by our Board. One, which envisages the concurrent repeal of Glass-Steagall and the McFadden Act, would obviously prove controversial to large segments of the affected industries. It is included, however, for the purpose of demonstrating the critical competitive interlock between these two laws, if we are indeed embarked on a road looking to the extinction of Glass-Steagall. Under those circumstances, competitive equity would demand that securities organizations whose natural genius lies in nationwide marketing should not be deprived of the ability to provide banking services through these systems if they are forced to compete with giant banks that have well worked-out interstate correspondent relationships.

Again, I would assure you of our sincere desire to work with the Department of the Treasury and the Congress in attempting to reach a consensus on the proposed legislation. The amendments we have suggested are not designed for any purpose other than to deal with the problems of public protection and competitive equity in a fair and balanced manner. We regret that the legislation proposed to date fails to meet these objectives.

We would be pleased to meet with you to discuss the specific concerns and suggestions set forth in the attached memorandum.

Sincerely yours,

David Silver

Enclosures

SUMMARY OF PROPOSED AMENDMENTS

A - Place bank common trust funds and collective investment funds for retirement plans under the federal securities laws.

B - Place bank investment advisory services under the federal securities laws.

C - Place issuance of a bank's own securities and bank broker-dealer activities under the federal securities laws.

D - Prohibit a bank and its affiliated mutual fund from having similar names.

E - Prohibit a bank from engaging in sales activities on behalf of its affiliated mutual fund.

F - Prohibit a bank and its affiliated mutual fund from having common personnel.

G - Strengthen current anti-tying provisions by prohibiting the tying of loans and trust services and by creating a presumption of unlawful tying where a significant number of bank trust or mutual fund customers receive other services from the bank.

H - Prohibit dumping of shares of the bank's affiliated mutual fund into fiduciary accounts managed by the bank.

I - Prohibit a bank affiliated mutual fund from investing in a company which is a borrower from the bank in order to facilitate repayment of loans to the bank. Also would prohibit a bank affiliated mutual fund from investing in securities issued or sold by other banks in the bank's correspondent system.

J - Prohibit a bank from making loans to a company in which the bank's affiliated mutual fund has invested in order to support the mutual fund.

K - Prohibit a bank from making loans to a customer to finance the customer's investment in the bank's affiliated mutual fund.

L - Permit all securities firms to engage in the banking business on a nation-wide basis and permit banks to engage in all securities activities.

M - Grant mutual fund sponsors trust powers upon the filing of certificates of election with the Comptroller of the Currency.

N - Strengthen the bill's restrictions on transactions between the bank and its securities affiliate.

O - Provide private rights of action for persons injured by violations of the Glass-Steagall Act.

P - Provide expedited treatment for reorganizations of mutual fund sponsors into holding companies, similar to the bill's treatment of reorganizations of banks into holding companies.

Q - Provide improved grandfather rights for companies owning a "non-bank" bank or a single thrift institution.

R - Extend the due process rights granted by the bill to banks to securities firms.

MAJOR DEFECTS IN THE PROPOSED FINANCIAL INSTITUTIONS DEREGULATION ACT OF 1983 AND SUGGESTED AMENDMENTS

INTRODUCTION

The Investment Company Institute submits this memorandum which identifies major deficiencies in the Treasury Department's proposed Financial Institutions Deregulation Act of 1983 and which suggests specific amendments designed to remedy them. The deficiencies in the bill can be grouped into three major categories.

First, although the bill ostensibly embodies the concept of "regulation by function," the bill totally fails to implement that concept by permitting banks to continue to engage in many securities activities outside the realm of the federal securities laws. Second, although the bill greatly expands the scope of permissible bank securities activities, the bill fails adequately to address the conflicts of interest, financial hazards and other abuses that are likely to result from these new activities. Third, although the bill purports to broaden the scope of permissible bank activities in order to enhance competition,* the bill in fact would create a playing field tilted sharply and unfairly in favor of large banks, at the expense of the members of the securities industry in general, and of the mutual fund industry in particular.

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*/ *See* *Letter dated July 8, 1983, from Treasury Secretary Donald T. Regan to House Speaker Thomas P. O'Neill, Jr.* at 1.

This memorandum discusses each of these three problem areas seriatim, and suggests amendments to remedy the major deficiencies identified below.

I. REGULATION BY FUNCTION -- EXISTING BANK SECURITIES ACTIVITIES

The interrelated network of statutes currently applicable to the members of the financial services industry implicitly embodies the concept of "regulation by function." For although the statutes speak in terms of industry classifications -- "bank" versus "securities firms" versus "thrifts" -- those industry classifications themselves reflect the nature of the functions Congress intended these various types of regulated institutions to perform.

Thus, when Congress enacted the federal securities laws in the period 1933-1940, it exempted commercial banks from regulation under those laws because Congress believed that, by enacting the Glass-Steagall Act, it successfully had removed banks from virtually all aspects of the securities business. As the General Counsel of the Securities and Exchange Commission recently testified before the House Subcommittee on Commerce, Consumer and Monetary Affairs: "Since the Glass-Steagall Act was thought, as a general matter, to exclude banks from the securities business, the securities laws, in turn, exempt banks from most facets of securities regulation."*

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* *See* *Statement of Daniel L. Goelzer, General Counsel, Securities and Exchange Commission, Before the House Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations*, at 3-4 (July 20, 1983). *Accord* *Statement of K. Houston Matney, Chairman of Financial Institutions Committee of the North American Securities Administrators Association and Securities Commissioner of the State of Maryland Before the Senate Committee on Banking, Housing, and Urban Affairs*, at 5 (June 16, 1983).

However, over the ensuing decades, the nation's largest commercial banks have embarked upon major securities activities involving millions of investors and billions of dollars. Banks sponsor and distribute common trust funds and collective investment funds with assets of over $130 billion. Banks render investment advice to millions of investors and currently manage assets of over $689 billion, making banks the nation's largest money managers. Banks issue and distribute their own securities to the public. Banks perform brokerage services, sell third-party commercial paper and mass-market retail repurchase agreements. As a result of these activities, banks not only have eroded the principle of functional regulation underlying the existing statutory framework, but also conduct these and other securities activities completely free from regulation under the federal securities laws.

The advantages of, and the need to return to, a statutory scheme premised upon regulation by function have been well documented, and need not be repeated again here. As SEC Chairman Shad has explained, the allocation of regulatory jurisdiction by function is essential in order to assign to each regulatory agency jurisdiction over those economic functions it knows best, to permit the application of a consistent regulatory philosophy, to minimize regulatory conflicts, duplication, and overlap, and to establish the conditions for equal treatment of competitors.[*]

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[*] *Hearings on S. 1720 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 97th Cong., 2nd Sess. 35 (1982) ("1982 Hearings") (Statement of SEC Chairman John S. R. Shad) ("Shad Statement").

The Department of the Treasury itself has recognized that any financial services industry legislation must return to the principle of regulation by function and must subject existing bank securities activities to regulation under the federal securities laws. Thus, in 1981 and 1982, Secretary Regan testified before the Senate Banking Committee and its Securities Subcommittee that, under the Treasury bill, any bank electing to create a securities affiliate would have to transfer "all other traditional securities business" and "all securities, brokerage, underwriting and dealing activities" carried on by the bank to the affiliate, and thereby subject these activities to regulation under the federal securities laws.*

However, the bill as presently drafted fails to implement Secretary Regan's stated program. For example, under the bill, commercial banks could continue to sponsor and distribute common trust funds and collective investment funds, render investment advice to millions of investors, mass-market the bank's own securities to the public, and perform securities brokerage activities completely free from regulation under the federal securities laws. The bill's failure to deal with bank common and collective funds is particularly surprising since SEC Chairman Shad recently stated that the bill "should be extended to require that the management of all collective investment vehicles -- including

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* *Hearings on S. 1686, S. 1703, S. 1720, and S. 1721 Before the Senate Committee on Banking, Housing, and Urban Affairs, Part I*, 97th Cong., 1st Sess. 7 (1981) ("1981 Hearings Part I") (Statement of Treasury Secretary Donald T. Regan); *1982 Hearings* at 3 (Statement of Treasury Secretary Donald T. Regan).

common trust funds and pooled employee benefit plans -- be carried out within a separate corporate affiliate."*

Three of the attached amendments would implement Secretary Regan's stated goal of requiring *all* bank securities activities to be conducted in separate affiliates and made subject to regulation under the federal securities laws.

-- Amendment A would amend the federal securities laws to delete the exemptions for bank common and collective funds and would require a bank to transfer its common and collective funds to a securities affiliate. This amendment would carry out Chairman Shad's specific proposal quoted above, a proposal previously endorsed by Governor Partee of the Federal Reserve Board.**

-- Amendment B would delete the exemptions in the federal securities laws for banks which act as investment advisers and would require a bank which establishes a securities affiliate to transfer its investment advisory activities to the affiliate. Former SEC Chairman Williams previously has proposed a similar approach.***

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* *See Statement of John S. R. Shad, Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs* at 20 (June 8, 1983).

** *See 1982 Hearings* at 42 (Statement of FRB Governor J. Charles Partee).

*** *Hearings on H.R. 1539, H.R. 2747 and H.R. 2856 Before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs* 96th Cong., 1st Sess. 17 (1979) (Statement of SEC Chairman Harold Williams).

-- Amendment C would amend the federal securities laws to delete the registration exemptions for securities issued by a bank or by a savings and loan association, would grant the SEC disclosure jurisdiction over the issuance of such bank securities, and would delete the exemptions in the securities laws for banks which act as brokers and dealers. Chairman Shad called for these precise reforms in his recent testimony before the Senate Banking Committee.*

II. PUBLIC PROTECTION

The Glass-Steagall Act represents Congress' considered legislative judgment that "policies of competition, convenience or expertise which might otherwise support the entry of commercial banks into the investment [company] business [are] outweighed by the 'hazards' and 'financial dangers' that arise" when commercial banks engage in that business.** The history of bank sponsorship of investment trusts in the 1920s and subsequent bank sponsorship of other pooled investment vehicles (*e.g.*, bank sponsorship of real estate investment trusts in the early 1970s and current-day bank sponsorship of common and collective funds) confirms the wisdom of that judgment.*** It also highlights the unique public

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* *Shad Statement* at 12, 15.

** *Investment Company Institute* v. *Camp*, 401 U.S. 617, 630 (1971) ("Camp").

*** Indeed, following the debacle of the 1920s, bankers themselves testified that the problems associated with bank and bank affiliate sponsorship of investment companies were so great that these activities should be totally prohibited in the future. *See*, *e.g.*, *Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies Part III*, at 136, 179 (1939-1940) (Statement of the Chairman, Chatham Phoenix National Bank and Trust Company of New York, and the President, Central Trust Company of Illinois).

protection issues raised by the Department's proposal to reverse that judgment and to permit banks to sponsor mutual funds through affiliates of their parent holding companies.

Secretary Regan himself has recognized that bank affiliate mutual fund activity "does raise all the traditional Glass-Steagall concerns".* Especially in light of this concession, it is incumbent upon the Department to ensure that any legislation repealing the Glass-Steagall Act contains safeguards adequate to address and ameliorate all these "traditional Glass-Steagall concerns." While Secretary Regan has expressed the belief that "our proposed legislation, in company with existing banking and securities laws, provides adequate safeguards,"** history and the cumulative experience of numerous experts in this area proves otherwise.

As Chairman Garn and others have repeatedly pointed out, the mere creation of an affiliate does not, and cannot, eradicate the myriad conflicts of interests, financial dangers, and other abuses which existed in the 1920s or which developed in connection with bank sponsored REITs during the 1970s. Moreover, the banking laws cannot provide adequate safeguards against these dangers, since the banking laws, according to the federal banking regulators, are designed solely to insure the safety and soundness of the banking system, and not to protect investors.***

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* 1982 Hearings at 6 (Statement of Treasury Secretary Donald T. Regan).

** Id.

*** See, e.g., A. G. Becker Incorporated v. Board of Governors, 693 F.2d 136 (D.C. Cir. 1982), petition for cert. filed, No. 82-1766 (April 29, 1983).

Finally, the existing securities laws cannot provide adequate safeguards because they are premised upon the assumption that the activities regulated thereunder are forbidden to banks.

For example, the Investment Company Act was enacted by Congress to deal with the unique and specific conflicts which arise when investment banking firms, brokerage firms and investment advisers sponsor, manage and distribute the shares of mutual funds.[*] However, because Congress believed that it successfully had excluded banks from the investment company business, the Act does not purport to deal with the unique conflicts of interest which result when commercial banks or their affiliates engage in the mutual funds business. As SEC Chairman Shad has testified:

> [t]he Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Therefore, the Investment Company Act could not address the problem of bank conflicts of interest specifically.[**]

In short, if affiliates of commercial banks are to be permitted to organize, sponsor and distribute the shares of mutual funds, it will be necessary to revise the Investment Company Act to deal with the unique conflicts of interest which will result.

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[*] The typical pattern used in the 1940 Act is to prohibit specific types of potential conflict of interest transactions involving specific types of firms, while authorizing the SEC to issue exemptive orders and rules in appropriate cases.

[**] *Hearings on S. 1686, S. 1703, S. 1720, and S. 1721 Before the Senate Committee on Banking, Housing, and Urban Affairs, Part II*, 97th Cong., 1st Sess. 914 (1981) ("1981 Hearings Part II") (Statement of SEC Chairman John S. R. Shad).

Attached are a number of amendments which address the major hazards which have been identified by Chairman Shad, Chairman Volcker, Governor Partee and other witnesses, and which have occurred in the past when banks and their affiliates sponsored pooled investment vehicles.

-- Amendment D would prohibit a bank, its securities affiliate and any related mutual fund from having similar names. This amendment, which specifically was suggested by Chairman Volcker,* is designed to prevent public confusion between the bank and its affiliated mutual fund.

-- Amendment E is also designed to prevent public confusion by prohibiting a bank, among other things, from:

> distributing prospectuses or sales literature relating to its affiliated mutual fund;
>
> rendering investment advice to the public with respect to the advisability of investing in its affiliated mutual fund;
>
> furnishing the names of its depositors to its affiliated mutual fund or its securities affiliate; and
>
> maintaining its offices in any building which is likely to be identified by the public with its affiliated mutual fund.

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* *1981 Hearings Part II* at 466 (Statement of FRB Chairman Paul Volcker). *Accord* *1982 Hearings* at 89 (Statement of Robert Charles Clark, Professor, Harvard Law School) (The bill "should prevent affiliates from having names that are substantially similar to that of the member bank. Merely telling bank holding companies not to lie, not to affirmatively mislead people, is not enough to prevent identity confusion of the sort that's of concern here, and letting affiliates have similar names will increase the chance of confusion").

It should be noted that this amendment is based on the restrictions contained in present Federal Reserve Board Regulation Y governing the relationship between closed-end investment companies and their bank holding company subsidiary investment advisers.*

-- Amendment F would recodify Section 32 of the Glass-Steagall Act to require that a bank have different officers, directors and employees than its securities affiliate and affiliated mutual fund, while expanding its reach to include all depository institutions and not merely Federal Reserve System member banks. This amendment is designed both to prevent public confusion and to strengthen the separation between the bank and its securities affiliate and affiliated mutual fund. Indeed, following the debacle of the 1920s, bankers themselves testified that major problems were created when banks, their securities affiliates and investment companies shared the same officers.**

-- Amendment G would amend the anti-tying provisions of the Bank Holding Company Act and the Home Owners' Loan Act to

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* *See* 12 C.F.R. §225.125 (1983).

** *See* *Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies*, *supra*, at 179 (Statement of the President, Central Trust Company of Illinois) ("Any conscientious officer will try to administer each of those three companies for its own best interest. As long as your security market is stable or inclining upward, as long as you are in a period of reasonable prosperity, I feel that that sort of relationship is endurable. But, once the reverse takes place, then your officers are in constant embarrassment").

prohibit a bank from tying the granting of credit to a customer's acquisition of trust services. The amendment would also extend the anti-tying provisions to include securities affiliates as well as banks themselves. In addition, the amendment would address the difficult problems of proof presented under current law* by codifying a presumption that a bank or its securities affiliate has engaged in unlawful tying arrangements whenever a significant number of the bank's trust customers at the same time receive other services from the bank or its affiliates, or when a significant number of a securities affiliate's mutual fund customers at the same time receive other services from the bank or its affiliates. Finally, Amendment G preserves the private right of action for trade associations to redress violations of the tying prohibitions of the Bank Holding Company Act and the Home Owners' Loan Act presently contained in the bill. In this respect, it should be noted that Senators D'Amato and Hecht,** SEC Chairman Shad*** and Assistant Attorney General

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* *See, e.g., Transcript of Hearings Before the House Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce* at 52 (June 16, 1983) (Statement of SEC Chairman John S. R. Shad) ("[T]here are prohibitions against tie-ins, but they are extremely difficult to police, whether or not it is implicit when a bank makes a loan that it is going to do take-out financing for instance").

** *Transcript of Hearings on Conditions in the Financial Institutions Industry Before The Senate Committee on Banking, Housing, and Urban Affairs* at 37-38, 42-44 (April 6, 1983).

*** *See Transcript of Hearings on Finance Institutions Industry Before the Senate Committee on Banking, Housing, and Urban Affairs* at 71-73 (June 8, 1983) (Statement of SEC Chairman John S. R. Shad).

Baxter* all have identified the tying of loans to the provision of other products and services as an area of major concern.

-- Amendment H would prevent banks from "dumping" securities issued by their affiliated mutual funds into bank-managed trust accounts by prohibiting a bank from causing an account which it manages in a fiduciary capacity from purchasing shares of the bank's affiliated mutual fund, unless such purchase has been ordered by a court or is permitted by an SEC order or rule. The practices of "dumping" securities into bank trust accounts was one of the abuses that prompted the enactment of the Glass-Steagall Act,** and Senator Gorton recently expressed his concern that the bill contain provisions adequate to prevent any repetition of this practice.***

-- Amendment I would prohibit a mutual fund sponsored by a bank securities affiliate from investing in a company which is a borrower from the bank in order to facilitate repayment of the loans to the bank, with the SEC given the authority to issue exemptive orders and rules in appropriate cases. This abuse arose when banks and their affiliates sponsored investment companies in the 1920s,**** and was a major factor leading to the passage of the Glass-Steagall Act.* SEC Chairman Shad, in referring recently to this "most basic potential conflict of interest,"** suggested that Congress consider enacting specific provisions to ensure against any reoccurrence of this practice.***

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* *Id.* at 105-106 (Testimony of William F. Baxter, Assistant Attorney General, Antitrust Division, Department of Justice).

** *See Camp supra*, 401 U.S. at 633.

*** *See Transcript of Hearings on Moratorium Legislation and Financial Institutions Deregulation Before the Senate Committee on Banking, Housing, and Urban Affairs* at 49-53 (July 18, 1983).

**** *See Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies*, *supra*, at 127.

Amendment I also would prohibit a bank from causing its mutual fund to purchase securities issued or sold by other banks in its correspondent system, with the SEC given authority to exempt such purchases in appropriate cases. This was an area of abuse in the 1920s when larger banks caused their affiliated investment companies to make such investments in order to enhance the bank's role as correspondent to smaller banks.****

-- Amendment J would prohibit a bank from making loans to a company in which the bank's affiliated mutual fund had invested in order to support the mutual fund, with the SEC given broad exemptive authority. This specific area of abuse again was one which prompted Congress to enact the Glass-Steagall Act.*

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* _See_ _Camp_, _supra_, 401 U.S. at 631.

** _See_ _1981 Hearings Part II_ at 914 (Statement of SEC Chairman John S. R. Shad) ("[P]erhaps the most basic potential conflict of interest of a bank is that between its interests as a creditor of a corporation to which it had made a commercial loan and its duty to consider the best interests of any investment company it managed in any situation where the investment company owned or considered purchasing securities issued by the same corporation").

*** _Id_. at 915.

**** _See_ _Report of Securities and Exchange Commission on In-Investment Companies and Investment Trusts_, _supra_, at 167.

-- Amendment K would prohibit a bank from making loans to a customer in order to finance the customer's investment in the bank's affiliated mutual fund, with the SEC given broad exemptive powers. As the Supreme Court has recognized, the history of bank investment company activities in the 1920's reveals that the promotional pressures of the securities business often tempted banks to engage in this misapplication of bank assets, with a resulting loss of public confidence in the bank when the customer suffered losses on the bank affiliate's securities.**

III. COMPETITIVE EQUITY

Although the Treasury Department has stated that the bill is intended to enhance competition in the financial services industry, enactment of the bill in its present form can only lead to the opposite result. Recent experience indicates that, rather than creating their own mutual fund organizations, large banks will simply buy existing large mutual fund organizations, thereby accelerating concentration. For example, when Bank of America recently decided to enter the discount brokerage business, it did not start a discount brokerage operation from scratch or even buy and then expand a small discount broker. Instead, the nation's largest bank simply bought the nation's largest discount broker.

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* Camp, supra, 401 U.S. at 631.

** Id. at 632.

Moreover, the bill is a one-way street. Although all banks, including the largest and most powerful ones, would be authorized under the bill to enter the mutual fund business, the nation's largest securities firms would continue to be prohibited from entering the banking business due to their corporate underwriting activities. Even those securities firms which could enter the banking business would be placed at a competitive disadvantage, because they then would face unfair competition from banking giants who already have grown and prospered under the special protections afforded by the banking laws--protections such as restricted entry into the banking business by would-be competitors; the geographical safe-harbors and "captive" correspondent systems resulting from the McFadden Act and the Douglas Amendment; monopoly profits from price fixed rates of return (Regulation Q); subsidization from cheap deposits (the prohibition against paying interest on demand deposits); limitation of competition among banks based on risk (FDIC insurance); and bank freedom from public disclosure under the federal securities laws.

In theory fair competition between securities firms and commercial banks could be achieved by redrafting the bill to do away with each and every one of the special privileges accorded to commercial banks. However, the Department of Treasury has not expressed the intention of making such wide-ranging changes in the banking laws nor would they seem to be desirable. Under these circumstances, the most appropriate course of action would

would be simply to repeal the Glass-Steagall Act, and thereby to permit all securities firms to enter the banking business while permitting banks to enter the full securities business.

Even this approach, however, would not produce a fair field of competition. The restrictions on geographical expansion contained in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act have led to a well developed nationwide correspondent system of banks through which the largest banks provide numerous services to "captive" smaller banks and in turn to their customers. As was recently recognized:

> Correspondent relationships with "country banks" provide [major banks] another captive market. Major banks offer their correspondents services such as check clearing, loan participations, lines of credit and investment advice in return for deposit balances. A natural allegiance to the respondents arises from this relationship....*

The large banks have made it clear that, if the Glass-Steagall Act is modified to permit bank affiliates to sponsor mutual funds, they intend to utilize these correspondent relationships to distribute the shares of their funds through their well-established chains of local banks. In each community these securities activities will be linked to the banking services provided by local banks to their banking customers. Thus, modification of the Glass-Steagall Act to permit bank affiliates to

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* Mehle, Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition, 26 Syracuse L. Rev. 1117, 1145 (1975).

sponsor mutual funds will give the large banks a major competitive advantage over traditional securities firms. This advantage will exist even if securities firms are permitted to exercise full banking powers in a single state since, as new entrants into the banking business, securities firms would be outside this correspondent system which has grown in the protectionist shelter of the McFadden Act and the Douglas Amendment. This competitive disadvantage can only be ameliorated by permitting securities firms to engage in multi-state banking activities.

-- Amendment L would deal with these problems by adding the underwriting of corporate securities to the list of permissible activities for securities affiliates and by repealing the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

We note that we offered a similar amendment when we testified regarding the Department's earlier bill.* We must assume, however, that the lack of response from the Department regarding our proposal indicates the Department is intent on seeking legislation which simply would provide a one-way street for large bank entry into the mutual fund business. If this is indeed the Department's intent, we would urge the adoption of at least the following provisions in order to try to bring some balance into what would be an extremely inequitable competitive situation.

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* 1982 Hearings at 414-15 (Statement of David Silver).

-- Amendment M would grant investment advisers to mutual funds trust powers upon the filing of certificates of election with the Comptroller of the Currency. Absent such a provision, Section 7 of the bill would prevent many members of the mutual fund industry from acquiring trust powers due to the mechanical application of the Bank Holding Company Act. In this connection it is essential to bear in mind that there is no logical connection between the business of banking and the rendering of trust services.*

-- Amendment N would amend the Department's proposed Section 23B of the Federal Reserve Act to prohibit loans, sales of securities, and other transactions between a bank and its securities affiliate unless the Federal Reserve Board first has determined that the terms of such transactions are comparable to those that would be extended to non-affiliated companies. Amendment N also would extend the reach of the Department's proposed Section 23B to encompass all depository institutions. Amendment N also would make clear that nothing in Section 23B shall affect or amend any provision of the Investment Company Act of 1940. Consistent with the terms of our proposed amendments D and H, Amendment N also would prohibit a bank and its securities affiliate and related mutual fund from using similar names, and would prohibit the "dumping" of securities into bank-managed trust accounts. Amendment N is designed to ensure that a bank securities affiliate receives no unfair advantage of any kind by virtue of its association with the bank.

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* *See* Scott, *Fifty Years of Trusts*, 50 *Harv. L. Rev.* 60, 62 (1936) ("It was perhaps something of an accident that the corporations which have obtained power to administer trusts are banking institutions. There is no necessary connection between the business of banking and the business of administering trusts. Indeed, many difficulties have arisen from the attempt to combine these two powers").

-- Amendment O would provide private rights of action for persons injured by violations of the Glass-Steagall Act. Although the courts have recognized the existence of an implied right of action under the Glass-Steagall Act on behalf of injured bank competitors,* this right of action should be expressly codified to ensure against claims that Congress intended those injured by unlawful bank conduct to have no judicial redress at all.

-- Amendment P would provide expedited treatment for reorganizations of mutual fund sponsors into holding companies. The bill presently provides expedited treatment for banks seeking to reorganize into holding company patterns, but fails to provide the same benefit to mutual fund firms. We are uncertain whether this omission is another example of the bill's one way street bias, or whether the omission is inadvertent. In either event, it should be corrected so that banks and mutual fund organizations are afforded equal treatment.

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* *See, e.g.*, *New York Stock Exchange, Inc.* v. *Bloom*, 562 F.2d 736, 742, 742 n. 5 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978); *American Society of Travel Agents, Inc.* v. *Bank of America National Trust & Savings Association*, 385 F.Supp. 1084 (N.D. Cal. 1974).

-- Amendment Q would provide improved grandfather privileges to any company owning a "non-bank" bank or a single thrift institution by striking the provision prohibiting such companies from engaging in any new activity subsequent to July 1, 1983 which is not permissible for a bank or savings and loan holding company, and by granting to the appropriate depository institution regulatory agency the authority to extend any forfeited grandfather privileges, in the public interest, for a period not to exceed one year. The requirement that a grandfathered non-bank or unitary savings and loan company refrain from engaging in any new activity not permissible for a holding company serves no legitimate purpose, would straightjacket existing securities firms, and is anticompetitive. The absence of authority to extend the grandfather privileges of securities firms is equally anticompetitive, since the bill grants such extensions to thrift service corporations engaged in the securities business.

-- Amendment R would extend the due process rights granted by the bill to banks and thrifts to all interested persons. As presently drafted, the bill is one-sided in extending to depository institutions the right to participate in agency proceedings and to obtain judicial review thereof, while expressly denying those same rights to members of the securities industry.

CONCLUSION

In conclusion, we simply wish to reiterate our disappointment that, although we offered a number of specific amendments which addressed many of the issues discussed in this memorandum

in testimony before Congress in both 1981 and 1982,* the
ment of the Treasury, with minor exceptions, simply has
our suggestions. We are hopeful that, on this occasi
Department will carefully consider and accept the specific
tions set forth in this memorandum.

The lessons of history teach that, given the i
conflicts of interest and other hazards that arise whe
engage in the securities business, it simply will not do
to amend the Glass-Steagall Act now and hope for the best
future. As Professor James L. Pierce, Professor of Ec
University of California, recently warned:

> [N]ow is the time to build in safeguards rather than to wait until abuses appear. I fear that far too little has gone into designing safeguards and I know that the various pieces of proposed legislation before Congress pay scant attention to this problem.**

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* *See* *1982 Hearings* at 399-415 (Statement of David
1981 Hearings Part I at 839-53 (Statement of David Silver

** *Statement of James L. Pierce, Professor of Ec*
University of California, Before the House Committee on
Finance and Urban Affairs on Financial Institutions in a
tionary Era, 97th Cong., 1st Sess. 11 (Dec. 10, 1981).

A. PLACING BANK COMMON TRUST FUNDS AND COLLECTIVE INVESTMENT FUNDS UNDER THE FEDERAL SECURITIES LAWS

Amendments to the Securities Act of 1933

Sec. 26. Section 3(a)(2) of the Securities Act of 1933, as amended (15 U.S.C. 77c (a)(2)), is hereby amended by deleting, after the words "a Federal Reserve Bank", the words: "or any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian"; and by deleting, after the words "a single trust fund", the words "or in a collective trust fund maintained by a bank"; by deleting from the last sentence thereof the words: "a security issued or guaranteed by a bank shall not include any interest or participation in any collective trust fund maintained by a bank"; and by deleting from the last sentence thereof the words: "except that in the case of a common trust fund or similar fund or a collective trust fund, the term 'bank' has the same meaning as in the Investment Company Act of 1940."

Amendments to the Securities Exchange Act of 1934

Sec. 27. Section 3(a)(12) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c (a)(12)), is hereby amended by deleting the words: "any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian"; and by deleting the words: "or a collective trust fund maintained by a bank."

Amendments to the Investment Company Act of 1940

Sec. 28. Section 3(c)(3) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(3)), is hereby amended by deleting the words: "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian."

Sec. 29. Section 3(c)(11) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(11)), is hereby amended by deleting the words: "or any collective trust fund maintained by a bank consisting solely of assets of such trusts."

B. PLACING BANK INVESTMENT ADVISORY ACTIVITIES UNDER THE FEDERAL SECURITIES LAWS

Amendments to the Investment Advisers Act of 1940

Sec. 30. Section 202(a)(11) of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(a)(11)), is hereby amended by deleting the words "(A) any bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company," and by renumbering subparagraphs "(B)", "(C)", "(D)", "(E)", and "(F)" of Section 202(a)(11) as "(A)", "(B)", "(C)", "(D)", and "(E)", respectively.

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 11. Subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)), is hereby amended by deleting the penultimate sentence thereof and by adding a new paragraph (15) as follows: "(15) shares of any depository institution securities affiliate engaged in activities in accordance with the limitations contained in this paragraph:

"(i) No depository institution holding company that establishes or acquires any depository institution securities affiliate pursuant to this paragraph shall, after one year from the date on which any such depository institution securities affiliate first engages in any of the activities authorized under subparagraph (iii) of this paragraph, permit any depository institution controlled by such depository institution holding company to engage, directly or through a subsidiary, in the United States in any of the activities authorized under such subparagraph (iii) of this paragraph or any of the following activities, which are authorized pursuant to paragraph Seventh of Section 5136 of the

Revised Statutes of the United States, as amended (12 U.S.C. 24): dealing in and underwriting obligations of the United States, general obligations of any state of the United States or any political subdivision thereof and other obligations listed in paragraph Seventh of such Section 5136, [and] purchasing and selling securities and stock as agent[.], and acting as an investment adviser as defined in Section 202(a)(11) of the Investment Advisers Act of 1940, as amended. For purposes of this paragraph the Board may, by regulation or order, determine other securities or securities-related activities in which depository institutions may not engage. No rule, regulation or order of the Board, however, shall prohibit a depository institution from engaging in those securities or securities-related activities that are necessary or incidental to the financing of such depository institution or the investment of its funds. In the event that a depository institution holding company terminates all of the activities specified in subparagraph (iii) of this paragraph of its depository institution securities affiliate, any depository institution subsidiary of such holding company may conduct, directly or through a subsidiary, any securities or securities-related activities that it is authorized by law to conduct.

* * *

"(iii) In addition to the activities referred to in subparagraphs (i) and (ii) of this paragraph, such depository institution securities affiliate may --

"(A) deal in and underwrite all obligations issued or guaranteed by or on behalf of a state or any political subdivision thereof or any agency or instrumentality of either of the foregoing, except industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1954, as amended; provided, however, that depository institution securities affiliates may deal in and underwrite such industrial development bonds, the interest on which is exempt from Federal income tax under section 103(a) of the Internal Revenue Code of 1954, as amended, if: (1) a state, territory, possession of the United States, or any political subdivision of the foregoing, or the District of Columbia pledges its full faith and credit for the payment of all principal and interest on such bonds or (ii) the issuer, or the state or local governmental unit on behalf of which the industrial development bonds were issued, is considered the sole owner, for Federal income tax purposes, of the facility with respect to which financing is to be provided from the proceeds of such industrial development bonds;

"(B) organize, sponsor, operate, and control an investment company, as such term is defined in Section 3 of the Investment Company Act of 1940, as amended;

"(C) [render investment advice] act as investment adviser to[: (1) an investment company as described in subparagraph (B) above; and (2) any investment company other than a closed-end investment company] any investment company, as such terms are defined in Section 202(a)(11) of the Investment Advisers Act of 1940, as amended, and Section 3 of the Investment Company Act, as amended;

"(D) underwrite, distribute, and sell securities of any investment company, as such terms are defined in Section 3 of the Investment Company Act of 1940, as amended.

* * *

C. REPEAL OF EXISTING FEDERAL SECURITIES LAWS EXEMPTIONS FOR BANK SECURITIES AND BANK BROKER-DEALER ACTIVITIES

Amendments to the Securities Act of 1933

Sec. 31. Section 3(a)(2) of the Securities Act of 1933, as amended (15 U.S.C. 77c(a)(2)), is hereby amended by deleting after the words "or any certificate of deposit for any of the foregoing" the following: "or any security issued or guaranteed by a bank".

Sec. 32. Section 3(a) of the Securities Act of 1933, as amended (15 U.S.C. 77c (a)), is hereby amended by deleting subsection (5) in its entirety.

Amendments to the Securities Exchange Act of 1934

Sec. 33. Section 12 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78l), is hereby amended by deletting subsection (i) in its entirety.

Sec. 34. Section 3(a)(4) and Section 3(a)(5) of the Securities Exchange Act of 1934, as amended (15 U.S.C. §§78c(a)(4), 78c (a)(5)), are hereby amended by deleting therefrom the phrase "but does not include a bank."

D. PROHIBITION AGAINST USE OF A BANK'S NAME BY ITS SECURITIES AFFILIATE AND AFFILIATED MUTUAL FUND

Amendments to the Investment Company Act of 1940

Sec. 35. Section 35(d) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-34(d)), is hereby amended by adding the following language after the first sentence: "It is hereby declared to be deceptive and misleading for any depository institution securities affiliate or any regitered investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, a depository institution securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, or the Savings and Loan Holding ComCompany Amendments of 1967, as amended, of to adopt, as a part of the name or title of such company, or of any security of which it is the issuer, any words or words which are the same as, similar to, or a variation of, the name of any depository institution holding company, any depository institution or any other subsidiary of a depository institution holding company which is affiliated with such depository institution securities affiliate."

Amendments to the Federal Reserve Act

[Additions to the Administration Proposal are Underlined; Deletions From the Administration Proposal are in Brackets]

Sec. 15. (a) The Federal Reserve Act is amended by adding new Section 23B immediately following Section 23A (12 U.S.C. 371c) thereof to read as follows:

* * *

"(b) A member bank and the affiliates of such bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates[; however, a member bank and its affiliates may use similar names].

* * *

E. LESSENING OF PUBLIC CONFUSION BETWEEN BANKING FUNCTIONS AND AFFILIATED MUTUAL FUND ACTIVITIES

Amendments to the Investment Company Act of 1940

Sec. 36. Section 35 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-34), is hereby amended by adding the following new paragraph: "(e) It shall be unlawful for any depository institution which is affiliated with a depository institution securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, or as defined in the Savings and Loan Holding Company Amendments of 1967, as amended, or for any affiliated person of such depository institution other than such a depository institution securities affiliate, to engage, directly or indirectly, in the offer or sale of any securities issued by any investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, such depository institution securities affiliate. For purposes of this section, the term 'engage, directly or indirectly, in the offer or sale of securities of an investment company' shall include promoting or advertising such investment company or the securities issued by such investment company; distributing or making available prospectuses or sales literature relating to securities issued by such investment company; referring any customers or business to such investment company or such depository institution securities affiliate; rendering investment advice with respect to the advisability of investing in securities issued by such investment company; furnishing the names of depositors in such depository institution to such investment company or such depository institution securities affiliate; and the maintenance of offices by such investment company in any building which is likely to be identified with such depository institution or any affiliated person of such depository institution other than such depository institution securities affiliate."

F. PROHIBITION AGAINST OVERLAPPING PERSONNEL

Amendments to the Banking Act of 1933

[Additions to the Existing Statutory Language Are Underlined; Deletions From the Existing Statutory Language Are In Brackets.]

Sec. 37. Section 32 of the Banking Act of 1933, as amended (12 U.S.C. 78), is hereby amended to read as follows:

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve at the same time as an officer, director, of employee of any [member bank] depository institution. [except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.]

The term 'depository institution' as used in this section has the meaning ascribed to it by Section 1841(k)(2) of this Title (12 U.S.C. 1841(k)(2)) and Section 1730a(a)(1)(K)(ii) of this Title (12 U.S.C. 1730a(a)(1)(K)(ii)), and includes an uninsured institution as defined in Section 1730a(a)(1)(B) of this Title (12 U.S.C. 1730a(a)(1)(B)).

G. STRENGTHENED ANTI-TYING PROVISIONS

Amendments to the Bank Holding Company Act Amendments of 1970

[Additions to the Existing Statutory Language or the Administration's Proposal are Underlined; Deletions are in Brackets]

Sec. 38. Subsection 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972(1)) is hereby amended to read as follows:

(1) A bank or its depository institution securities affiliate shall not in any manner extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration for any of the foregoing, on the condition or requirement --

(A) that the customer shall obtain some additional credit, property, or service from such bank or from such depository institution securities affiliate other than a loan, discount, or deposit[, or trust service];

(B) that the customer shall obtain some additional credit, property, or service from a bank holding company of such bank or from any other subsidiary of such bank holding company, including a depository institution securities affiliate;

(C) that the customer provide some additional credit, property, or service to such bank or such depository institution securities affiliate, other than those related to and usually provided in connection with a loan, discount, or deposit[, or trust service];

(D) that the customer provide some additional credit, property, or service to a bank holding company of such bank or to any other subsidiary of such bank holding company, including a depository institution securities affiliate;

(E) that the customer shall not obtain some other credit, property, or service from a competitor of such bank, a bank holding company of such bank, or any subsidiary of such bank holding company, including a depository institution securities affiliate, other than a condition or requirement that such bank shall reasonably impose in a credit transaction to assure the soundness of the credit.

[The Board may by regulation or order permit such exceptions to the foregoing prohibition as it considers will not be contrary to the purposes of this chapter.] If a significant number of customers of any bank receive trust services from such bank and at the same time receive other credit, property, or services from such bank, from a holding company of such bank or from any other subsidiary of such holding company, including a depository institution securities affiliate, it shall be presumed that such bank obtained the trust business of all such customers in violation of this section. In addition, if a significant number of customers of any depository institution securities affiliate own securities of any registered investment company organized, sponsored, operated, controlled, or advised by such depository institution securities affiliate, and at the same time receive other credit, property, or services from such depository institution securities affiliate, from a holding company of such depository institution securities affiliate, or from any other subsidiary of such holding company, including a depository institution, it shall be presumed that the securities owned by all such customers were sold to such customers in violation of this section.

Sec. 17. Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972, *et seq.*) is hereby amended by adding new subsection (i) at the end thereof to read as follows:

"ACTIONS AUTHORIZED TO BE COMMENCED
BY TRADE ASSOCIATIONS

"Any action for injunctive relief that may be commenced by any person pursuant to Section 1976 of this title, may be commenced on the behalf of such person by any trade association of which such person is a member, provided that any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any such person pursuant to section 1976 of this title.".

Amendments to the Home Owners' Loan Act of 1933

[Additions to the Existing Statutory Language or the Administration's Proposal are Underlined; Deletions are in Brackets]

Sec. 24. Subsection 5(q) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464 (q)) is amended --

(1) by amending subsection 5(q)(1) to read as follows:

(q)(1) An association or its depository institution securities affiliate shall not in any manner extend credit, lease or sell property of any kind, or or furnish any service, or fix or vary the consideration for any of the foregoing, on the condition or requirement --

(A) that the customer shall obtain additional credit, property, or service from such association or from any service corporation or affiliate of such association, including a depository institution securities affiliate, other than a loan, discount, or deposit[, or trust service];

(B) that the customer provide additional credit, property, or service to such association, or to any service corporation or affiliate of such association, including a depository institution securities affiliate, other than those related to and usually provided in connection with a similar loan, discount, or deposit[, or trust service]; and

(C) that the customer shall not obtain some other credit, property, or service from a competitor of such association, or from a competitor of any service corporation or affiliate of such association, including a depository institution securities affiliate, other than a condition or requirement that such association shall reasonably impose in connection with credit transactions to assure the soundess of credit.

If a significant number of customers of any association receive trust services from such association and at the same time receive other credit, property or services from such association, from a holding company of such association, or from any other subsidiary of such holding company, including a depository institution securities affiliate, it shall be presumed that such association obtained the trust business of all such customers in violation of this section. In addition, if a significant number of customers of any depository institution securities affiliate own securities of any registered investment company organized, sponsored, operated, controlled, or advised by such depository institution securities affiliate, and at the same time receive other credit, property, or services from such depository institution securities affiliate, from a holding company of such depository institution securities affiliate, or from any other subsidiary of such holding company, including an association, it shall be presumed that the securities owned by all such customers were sold to such customers in violation of this section.

(2) by adding a new paragraph (6) to read as follows:

"(6) Any action for injunctive relief that may be commenced by any person pursuant to paragraph (2) of this provision, may be commenced on the behalf of such person by any trade association of which such person is a member, provided that any such action commenced by a trade association shall be subject to the same requirements, limitations and conditions as would be applicable had such action been commenced by any such person pursuant to paragraph (2) of this provision.".

H. PROHIBITION AGAINST DUMPING OF AFFILIATED MUTUAL FUND SECURITIES INTO BANK FIDUCIARY ACCOUNTS

Amendments to the Investment Company Act of 1940

Sec. 39. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(k) It shall be unlawful for any affiliated person of any depository institution securities affiliate, as defined in Section 1841(j) and Section 1730a(a)(1)(K) of Title 12 of the United States Code, to purchase as fiduciary any securities issued by any registered investment company which is organized, sponsored, operated, or controlled by such depository institution securities affiliate, or which receives investment advice from such depository institution securities affiliate, unless such purchases are required by court order. The Commission may, by rules, and regulations or order permit such purchases which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms of which the Commission determines to be reasonable and fair and not to involve overreaching on the part of any person concerned."

I. PROHIBITION AGAINST MANIPULATION OF AFFILIATED MUTUAL FUND TO FACILITATE LOAN REPAYMENTS TO BANKS OR TO ASSIST CORRESPONDENT BANKS

Amendments to the Investment Company Act of 1940

Sec. 40. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(1) It shall be unlawful for any depository institution securities affiliate, as defined in Section 1841(j) and Section 1730a(a)(1)(K) of Title 12 of the United States Code, to cause any registered investment company which is sponsored, organized, operated or controlled by, or which receives investment advice from, such depository institution securities affiliate (1) to purchase any security issued by any issuer who was indebted at any time during such issuer's last fiscal year to any depository institution holding company company, any depository institution, or any other subsidiary of a depository institution holding company which is affiliated with such depository institution securities affiliate; and (2) to purchase any security or other property issued or sold as principal, by any depository institution which regularly receives correspondent services from any depository institution holding company, any depository institution or any other subsidiary of a depository institution holding company which is affiliated with such depository institution securities affiliate. For the purposes of this section, the term 'correspondent services' includes the acceptance of deposits and the performing of other banking or depository services. The Commission may, by rules and regulations or order, permit such purchases which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms which the Commission determines to be fair and reasonable and not to involve overreaching on the part of any person concerned."

J. PROHIBITION AGAINST BANK LOANS TO SECURITIES ISSUERS TO SUPPORT AFFILIATED MUTUAL FUNDS

Amendments to the Investment Company Act of 1940

Sec. 41. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(m) It shall be unlawful for any affiliated person of any depository institution securities affiliate, as defined in Sections 1841(j) and 1730a(a)(1)(K) of Title 12 of the United States Code, to lend any money, securities, or other property to any issuer any of whose outstanding securities are owned by any registered investment company organized, sponsored, operated, controlled or advised by such depository institution securities affiliate. The Commission may, by rules and regulations or order, permit such loans which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms of which the Commission determines to be fair and reasonable and not to involve overreaching on the part of any person concerned."

K. PROHIBITION AGAINST LOANS BY BANKS TO ENABLE CUSTOMERS TO PURCHASE SECURITIES OF AFFILIATED MUTUAL FUNDS

Amendments to the Investment Company Act of 1940

Sec. 42. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(n) It shall be unlawful for any affiliated person of any depository institution securities affiliate, as defined in Sections 1841(j) and 1730a(a)(1)(K) of Title 12 of the United States Code, to lend any money to any person to enable such person to purchase securities issued by a registered investment company organized, sponsored, operated or controlled by such depository institution securities affiliate, or which receives investment advice from such depository institution securities affiliate. The Commission may, by rules and regulations or order, permit such loans which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms of which the Commission determines to be fair and reasonable and not to involve overreaching on the part of any person concerned."

L. BANKING POWERS FOR SECURITIES FIRMS, SECURITIES POWERS FOR BANKS, AND REPEAL OF INTERSTATE BANKING RESTRICTIONS

Amendments to the Bank Holding Company Act

[Additions to the Administration Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 11. Subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)), is hereby amended by deleting the penultimate sentence thereof and by adding a new paragraph (15) as follows: "(15) shares of any depository institution securities affiliate engaged in activities in accordance with the limitations contained in this paragraph:

* * *

"(iii) In addition to the activities referred to in subparagraphs (i) and (ii) of this paragraph, such depository institution securities affiliate may --

* * *

"(E) sell, distribute, and underwrite stocks, bonds, debentures, notes and other securities.

* * *

Sec. 42. Section 3 of the Bank Holding Company Act, as amended (12 U.S.C. 1842), is amended by deleting subsection (d), known as the Douglas Amendment, in its entirety.

Amendments to the McFadden Act

Section 43. The McFadden Act, as amended (12 U.S.C. 36), is amended by repealing it in its entirety.

M. TRUST POWERS FOR THE MEMBERS OF THE MUTUAL FUND INDUSTRY

Amendments to the Investment Advisers Act of 1940 and Related Acts

Sec. 44. (a) The Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 et seq.) is hereby amended by adding a new section 80b-3A following section 80b-3:

"Notwithstanding paragraph 'Seventh' of Section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), Sections 20, 21, or 32 of the Banking Act of 1933 (12 U.S.C. 377, 378 or 78) the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), or the Saavings and Loan Holding Company Act Amendments of 1967 (12 U.S.C. 1730a), an investment adviser registered pursuant to 15 U.S.C. 80b-3 which on July 1, 1983, organized, sponsored, operated or rendered investment advice to an open-end investment company, or such adviser's parent, affiliate, or subsidiary, upon filing a certificate of election with the Comptroller of the Currency, may exercise all the trust powers of a national banking association as specified in 12 U.S.C. §92a(a); provided, however, that such adviser, or such adviser's parent, affiliate or subsidiary shall not be deemed a 'national banking association' for the purposes of the McFadden Act (12 U.S.C. 36) nor be deemed a 'bank' or 'bank holding company or subsidiary thereof' for the purposes of the Douglas Amendment to the Bank Holding Company Act (12 U.S.C. 1842(d))."

(b) Paragraph "Seventh" of Section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), is hereby amended by adding the words: "Except as provided in section 80b-3A of the Investment Advisers Act," before the words: "the business of dealing in securities and stock."

(c) Section 32 of the Banking Act of 1933 (12 U.S.C. 78), is hereby amended by adding the words: "Except as provided in section 80b-3A of the Investment Advisers Act," at the beginning of such section.

(d) Section 20 of the Banking Act of 1933 (12 U.S.C. 377), is hereby amended by adding the words: "except as provided in section 80b-3A of the Investment Advisers Act," before the words: "no member bank shall be affiliated in any manner."

(e) Section 21 of the Banking Act of 1933 (12 U.S.C. 378), is hereby amended by adding the words: "except as provided in section 80b-3A of the Investment Advisers Act," before the words: "to engage at the same time to any extent whatever."

N. STRENGTHENED PROHIBITIONS AGAINST BANK SUPPORT OF SECURITIES AFFILIATES

Amendments to the Federal Reserve Act

[Additions to the Administration Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 15. (a) The Federal Reserve Act is amended by adding new Section 23B immediately following Section 23A (12 U.S.C. 371c) thereof to read as follows:

"Sec. 23B. RESTRICTIONS ON TRANSACTIONS WITH AFFILIATES. -- (a) A [member bank] depository institution and its subsidiaries may not engage in any of the following transactions, unless the Board first has determined that the [only on] terms and [under] circumstances, including credit standards, of the transaction [that] are substantially the same as, or at least as favorable to, such [bank] depository institution or its subsidiary as those prevailing at the time for comparable transactions with or involving other non-affiliated companies or, in the absence of comparable transactions, those terms and circumstances that in good faith would be offered to, or would apply to non-affiliated companies, so that no unfair benefit, whether such benefit may be in the form of financial, business, or any other support, inures to an affiliate by virtue of its association with the depository institution and its subsidiaries:

"(1) any covered transaction, as defined in section 23A, with an affiliate;

"(2) the purchase or sale of securities or other assets, including assets subject to an agreement to repurchase, to or from an affiliate;

"(3) the payment of money or the furnishing of services to an affiliate, under contract, a lease, or otherwise;

"(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the [bank] depository institution or any other person; or

"(5) any transaction or series of transactions with a third party, (A) if an affiliate has a financial interest in the third party, or (B) if an affiliate is a participant in such transaction or series of transactions.

For the purposes of this subsection, any transaction by a [member bank] depository institution with any person shall be deemed to be a transaction with an affiliate of such [bank] depository institution to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, such affiliate.

"(b) A [member bank] depository institution and the affiliates of such [bank] depository institution shall not publish any advertisment or enter into any agreement stating or suggesting that the [bank] depository institution shall in any way be responsible for the obligations of its affiliates[; however, a member bank and its affiliates may use similar names].

"(c) A [member bank] depository institution and any subsidiary of such [bank] depository institution --

"(1) shall not purchase as fiduciary any securities or other assets from any affiliate unless such purchases are required [permitted under the instrument creating the fiduciary relationship,] by court order[, or by law of the jurisdiction under which the trust is administered]; and

"(2) [whether] acting as principal [or fiduciary], shall not knowingly or otherwise acquire, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an affiliate of such [bank] depository institution; except that this prohibition shall not apply where the Board in advance has approved the purchase of such securities as consistent with the public interest and as not involving overreaching on the part of any person.[has been approved, prior to the time at which such securities are initially offered for sale to the public, by a majority of the directors of the bank who are not officers or employees of the bank or any affiliate thereof.]

For the purpose of this paragraph, the term 'security' means a 'security' as defined in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)[(12)](10)); and the term 'principal underwriter' means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

"(d) For the purpose of the section --

"(1) the term 'affiliate' means an 'affiliate' as defined in Section 23A of the Federal Reserve Act (12 U.S.C. 371c) excluding a bank; and

"(2) the terms ['bank,] 'subsidiary', 'person', and 'security' (other than security as used in subsection (c)) have the same meanings given to them in Section 23A of the Federal Reserve Act (12 U.S.C. 371c)."

"(3) the term 'depository institution' has the meaning ascribed to it by Section 1814(k)(2) of this Title (12 U.S.C. 1841(k)(2)) and Section 1730a(a)(1)(K)(ii) of this Title (12 U.S.C. 1730a(a)(1)(K)(ii)), and includes an uninsured institution as that term is defined in Section 1730a(a)(1)(B) of this Title (12 U.S.C. 1730a(a)(1)(B))."

"(e)[The Board may prescribe rules and regulations to administer and carry out the purposes of this section, including rules or regulations to (1) further define terms used in this section; (2) exempt transactions or relationships from the requirements of this section; or (3) exclude from the definition of 'affiliate' in this section any subsidiary of a bank holding company, if the Board finds such exemptions or exclusions to be in the public interest and consistent with the purpose of this section.] Nothing in this title shall be deemed to authorize the Board to exempt any person, transaction or relationship from the requirements of the federal securities laws, as that term is defined in Section 21(g) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78u(g)). Furthermore, nothing in this title shall be deemed to alter, affect, amend, invalidate, or repeal any provision of the Investment Company Act of 1940.

* * *

O. EXPRESS GLASS-STEAGALL ACT PRIVATE RIGHT OF ACTION

Amendments to the Banking Act of 1933

Sec. 45. Section 21 of the Banking Act of 1933, as amended (12 U.S.C. §378), is hereby amended to add the following new subparagraph (c):

(c)(1) Any person injured by reason of any conduct forbidden in sections 24 (Seventh), 78, 377, and 378 of this title may bring suit in any United States district court where the defendant resides, or is found, or transacts business, or has an agent, to recover the damages sustained by him, or to obtain injunctive or other equitable relief.

(c)(2) Any action to enforce any cause of action under subsection (c)(1) shall be forever barred unless commenced within six years after the cause of action accrued.

(c)(3) Any action for injunctive or other equitable relief that may be commenced by any person pursuant to subsection (c)(1) may be commenced on behalf of such person by any trade association of which such person is a member, provided that any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any person pursuant to subsection (c)(1).

F. EXPEDITED CONVERSION PROCEDURES

Amendments to the Securities Act of 1933

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 4. Section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77d), is hereby amended by adding [a] new paragraphs (7) and (8) at the end thereof:

"(7) transactions involving offers or sales of equity securities, in connection with the acquisition of a bank by a company under the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*), or in connection with the acquisition of an insured institution by a company under the Savings and Loan Holding Company Amendments of 1967, as amended (12 U.S.C. 1730a), if such acquisition occurs solely as part of a reorganization in which a person or group of persons exchange their shares of a bank or insured institution for shares of a newly formed bank holding company or savings and loan holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the bank or insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law.

"(8) transactions involving offers or sales of equity securities, undertaken in order to form a company to acquire a bank under the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.), or in order to form a company to acquire an insured institution under the Savings and Loan Holding Company Act Amendments of 1967, as amended (12 U.S.C. 1730a), if the formation of such company occurs solely as a reorganization in which a person or group of persons exchange their shares of an existing company for shares of the newly formed company and receive, after such reorganization, substantially the same proportional share interest in the newly formed company as they held in the existing company, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law.

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 8. Subsection 3(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842(a)), is hereby amended by adding the following immediately preceding the period at the end of the second sentence of such subsection:

";[or] (C) with 30 days prior notification to the Board, the acquisition by a company of control of a bank in a reorganization in which a person or group of persons exchange their shares of the bank for shares of a newly formed bank holding company and receive, after such reorganization substantially the same proportional share interest in the holding company as they held in the bank except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law, provided that, immediately following such acquisition, the bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing and controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank immediately following the reorganization than is required for a similarly sized bank that is not a subsidiary of a bank holding company [.".]", or, with 30 days prior notification to the Board, the formation of a company to acquire control of a bank in a reorganization in which a person or group of persons exchange their shares in an existing company for shares of a newly formed company and receive, after such reorganization, substantially the same proportional share interest in the newly formed company as they held in the existing company except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law, provided that, immediately following the acquisition of a bank by the newly formed company, the resulting bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing or controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank immediately following its acquisition than is required for a similarly sized bank that is not a subsidiary of a bank holding company.".

Amendments to the Savings and Loan Holding Company Act Amendments of 1967

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 21. Subsection (e) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(e)) is hereby amended by amending clause (ii) of subparagraph (1)(B) to read as follows, and by adding the following clause (iii):

"(ii) acquired in connection with a reorganization in which a person or group of persons exchange their shares of an insured institution for shares of a newly formed holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law[.] , or (iii) acquired subsequent to a reorganization in which a person or group of persons exchanged their shares of an existing company for shares of a newly formed company and received, after such reorganization, substantially the same proportional share interest in the newly formed company as they held in the existing company, except for changes in shareholder interest resulting from the exercise of dissenting shareholder rights under state law.".

Q. IMPROVED GRANDFATHER RIGHTS FOR COMPANIES OWNING NON-BANK BANKS AND SINGLE THRIFTS

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 9. Section 4(a)(2) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(a)(2), is hereby amended to read as follows --

* * *

"Provided further, (I) That the two-year period referred to in this paragraph shall not apply to a company that becomes a bank holding company as a result of enactment of the Financial Institutions Deregulation Act and that acquired a bank between July 1, 1983, and the effective date of such Act; and (II) That a company that becomes a bank holding company as a result of the enactment of the Financial Institutions Deregulation Act, and that controlled an insured bank on July 1, 1983, may engage in any activity in which it was lawfuly engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983, provided that any activities authorized for bank holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions and limitations applicable to bank holding companies. The authority conferred by the preceding clause (II): (a) shall terminate at such time as (1) any covered bank holding company acquires control of an additional bank or an insured institution, or (2) its existing subsidiary bank commences accepting deposits that the depositor has a legal right to withdraw on demand and engages in the business of making commercial loans[, or (3) any covered bank holding company commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those activities authorized pursuant to this Act (except for the acquisition of an insured institution), in which it was not engaged on July 1, 1983]; and (b) may be terminated by the Board by order, after opportunity for hearing, if it determines, having due regard to the purposes of this chapter, that such action is necessary to prevent conflicts of interest or unsound banking practices or is in the public interest[.".]: Provided, however, That the Board may, upon application by any such covered bank holding company, extend the authority conferred by this subsection for an appropriate period of time in the public interest, but in no event shall such period of time exceed one year.".

Amendments to the Savings and Loan Holding Company Act Amendments of 1967

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Section 19. Subsection (c) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(c)) is hereby amended to read as follows:

"(c)(1) Except as otherwise provided in this subsection, no savings and loan holding company (except a unitary savings and loan holding company that acquires an insured institution pursuant to subsection (m) of this section) or subsidiary thereof which is not an insured institution shall --

* * *

"(B) commence or continue, after two years from the date as of which it becomes a savings and loan holding company, any business activity other than those specified in paragraph (2) of this subsection except that such two period shall not apply to any company that acquires an insured institution between July 1, 1983, and the effective date of authorized under paragraphs (8), (15) and (16) of this subsection consistent with the criteria in subparagraph (B)(iv) hereof and with safe and sound financial practices. In administering this paragraph, the Board shall promote competition between bank holding companies and all other companies engaged in activities of a financial nature or closely related to banking.

* * *

Amendments to the Savings and Loan Holding Company Act Amendments of 1967

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 19. Subsection (c) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(c)) is hereby amended to read as follows:

* * *

"(E) The Corporation shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Corporation order determining not to disapprove a proposal [to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this Section or in any other manner, provided, however, that] is reviewable pursuant to this Section on petition by any interested person (or a trade association acting on behalf of such a person), and any savings and loan holding company may obtain judicial review pursuant to this Section of any Corporation order not to disapprove a notice under this paragraph if such other contains rerestrictions or conditions.

* * *

The CHAIRMAN. Thank you very much, Mr. Silver.

Mr. O'Brien, we are going to reverse the alphabetical order.

STATEMENT OF EDWARD O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, NEW YORK

Mr. O'BRIEN. Thank you, Mr. Chairman. I am Edward O'Brien, president of the Securities Industry Association. I want to thank you for giving us the opportunity to appear here today and I also want to thank Senator Garn for his kind remarks a while ago, even though we do have disagreements from time to time. With me is Robert Downey, vice chairman of the SIA and a partner with Goldman, Sachs and Co.

I am here today to express a point of view on the subject on which I have often testified before, the Glass-Steagall Act.

[The complete prepared statement of Edward O'Brien follows:]

the Financial Institutions Deregulation Act. Provided, That any company that becomes subject, as a result of the Financial Institutions Deregulation Act, to the prohibitions of this subparagraph and that controlled an insured institution prior to July 1, 1983, may engage in any activity in which it was lawfully engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983, provided that any activities authorized for savings and loan holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions and limitations applicable to savings and loan holding companies. The authority conferred by the preceding proviso, (A) shall terminate at such time as any covered savings and loan holding company (i) acquires a bank, or its subsidiary insured institution fails to qualify as a domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954[, or (ii) commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those authorized pursuant to this Act to be permissible for savings and loan holding companies (except for the acquisition of a bank), in which it was not engaged on July 1, 1983,] or (B) may be terminated by the Corporation, after opportunity for hearing, if it determines, having due regard to prevent conflicts of interests, unsound practices, or in the public interest[.]; Provided, however, that the Board may, upon application by any such covered savings and loan holding company, extend the authority conferred by this subsection for an appropriate period of time in the public interest, but in no event shall such period of time exceed one year.

R. DUE PROCESS PROTECTIONS FOR MEMBERS OF THE SECURITIES INDUSTRY

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 10. Paragraph 8 of subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)(8)), is hereby amended to read as follows:

* * *

"(v) The Board shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Board order determining not to disapprove a proposal [to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this Act or in any other manner; provided, however, that] is reviewable pursuant to Section 9 of this Act upon petition by any interested person (or a trade association acting on behalf of such a person), and any bank holding company may obtain judicial review pursuant to section 9 of this Act of any Board order not to disapprove a notice under this paragraph if such order contains restrictions or conditions.

"(vi) The Board shall, within one hundred and eighty days of enactment of the Financial Institutions Deregulation Act and from time to time thereafter, promulgate regulations under this paragraph designating particular activities that are closely related to banking or of a financial nature. A bank holding company may petition the Board to determine by regulation that a particular activity is closely related to banking or of a financial nature[.], and any interested person (or a trade association acting on behalf of such a person) may oppose such petition. The Board may by regulation prescribe limitations on the conduct of any activity or activities

STATEMENT OF SECURITIES INDUSTRY ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

DECEMBER 8, 1987

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I. OVERVIEW

The Securities Industry Association ("SIA"), an association of more than 500 securities firms located throughout the United States and Canada, is grateful for the opportunity to appear before this Committee to provide its views on S. 1886, the Financial Modernization Act of 1987, S. 1891, the Financial Services Oversight Act, and S. 1905, the Depository Institution Affiliation Act. These bills would drastically alter this country's financial structure as it has existed for over half a century.

The Financial Modernization Act of 1987, S. 1886, introduced by Senators Proxmire and Garn, would break down that part of the barrier between banking and commerce known as the Glass-Steagall Act which has wisely separated federally-backed banks from most securities activities for more than 50 years. Under S. 1886, the federal safety net would be extended to cover all securities risks, and the resulting unfair competition would almost certainly result in bank domination of the securities industry and its disappearance as an independent industry. Since the Bank Holding Company Act is not otherwise amended under the bill, most larger securities firms could not affiliate with banking organizations, so the bill provides a one-way benefit for banks.

The Financial Services Oversight Act, S. 1891, introduced by Senators Wirth and Graham, would delegate to regulators the authority to allow federally-backed banks to engage in a wide variety of financial activities, including securities, insurance and real estate, thus making the financial sector a bank-dominated, completely regulated business devoid of alternatives and diversity and adding an enormous scope of risk to the federal safety net. The third bill, the Depository Institution Affiliation Act, introduced by Senators D'Amato and Cranston, in effect completely eliminates the Glass-Steagall and Bank Holding Company Acts insofar as their affiliation prohibitions are concerned, thus creating a brave new world where banking and commerce are one, a world in which anyone could own or be owned by a bank.

In our view, these bills, to a lesser or greater extent, are all headed in the wrong direction. Among the three bills, if there is to be any major overhaul immediately, the only fair bill is the Depository Institution Affiliation Act. SIA, however, has a more carefully staged plan to achieve comprehensive reform.

Each bill currently filed before this Committee serves to focus the ongoing debate about the proper range of activities of federally-backed banking organizations by presenting in legislative form an alternative restructuring proposal. But even apart from their direction, which we consider unwise, all of the bills are seriously flawed: They attempt to do too much, too fast. The first two bills are simply vehicles for bank expansion into the businesses of their customers without adequate concern for fair competition or limiting the exposure of risk to the taxpayer from non-banking activities. These bills ignore the principle that the federal government and the taxpayer support the banking system so that banks will perform their role of objective lender to the rest of society, not to support dealing in the capital markets or investments in real estate.

The tug-of-war of recent years between those who would maintain or reinforce the Glass-Steagall and the Bank Holding Company Acts' walls between banking and other industries and those who would tear them down has been incorrectly and dangerously characterized as nothing more than a turf battle among banks and financial services companies that do not want to compete with banks. Far more is at stake.

The securities industry, the financial sector with which SIA is most familiar, is highly competitive, even Darwinian. SIA and its members are not afraid of competition. SIA does, however, object to unfair competition, which we believe would be inevitable if banks, with their special advantages, are permitted into non-banking activities as contemplated by these three bills.

But there is a more fundamental objection to these bills that transcends parochial interests. Any measure that substantially increases the risk of exposure of the banking industry threatens to undermine the confidence in that industry that has been so painstakingly rebuilt since the 1930s. Banks, in their traditional functions as depository institutions and financial intermediaries, remain the essential strand of our economic fabric. Any loss of confidence in the integrity of our banking system could tear that fabric. That would be a disaster not only for banks, but for the securities industry and the nation as a whole.

SIA has been and remains a strong supporter of the Glass-Steagall Act's separation of commercial banking and investment banking, as well as of the Bank Holding Company Act's larger separation of banking and commerce -- of which, in a sense, Glass-Steagall is a part. Indeed, that separation should not be weakened, in our view, but strengthened. That separation has been instrumental in avoiding conflicts of interest and unfair bank competition, maintaining depositor confidence in the banking system, ensuring the safety of depository insurance funds and preventing undue concentration of economic power. The case for maintaining such separation remains at least as strong today as in the past. Indeed, current conditions and circumstances make the case stronger.

The health of our financial system depends on the effective insulation of insured deposits and the federal safety net from the risks of non-banking activities. The special advantages of banks likewise should be insulated so that they are not used unfairly against non-banking competitors in non-banking activities. However, proponents of the bills now being considered by the Committee, as well as backers of other proposals that would to a greater or lesser extent expand bank powers, apparently believe that the cake can be had and eaten too -- that banking organizations can engage in activities previously forbidden as too risky and involving a completely different set of risks from those involved in banking without jeopardizing the depository system.

The Financial Modernization Act of 1987 provides for only some modest restraints on bank subsidiaries dealing with securities subsidiaries of bank holding companies. The Financial Services Oversight Act is less specific about its protective structure, but clearly does not address the problem as a matter of special concern. The Depository Institution Affiliation Act, which prohibits banks from directly engaging in certain securites, real estate and insurance activities, does permit such activities to be conducted in a bank subsidiary or affiliate and suggests insulation within a banking organization.

The question no one knows the answer to is, "Will a barrier internal to a banking organzation work as well as barriers separating ownership of banking and non-banking functions?" Congress in the 1860s (the original separation of banking and commerce) and again in 1933 (the passage of Glass-Steagall to cancel out the disastrous experiment of bank ownership of securities affiliates legalized in 1927) did not think so. The question needs to be answered before significant change can be considered, because the stakes are too high to gamble. Assuming some desire to explore the question, how *do* we search out the answer in a safe and fair manner?

The Glass-Steagall wall was built on the premise that nothing short of a flat separation of federally-backed banking and securities activities would adequately isolate banks from undue risks and other businesses from unfair bank competition. Recent incidents such as the illegal rescue of First Options of Chicago by its parent bank and bank holding company suggest that the drafters of Glass-Steagall were right in being skeptical of reliance on corporate forms, legal constraints and promises for meaningful separation. Would an internal wall crumble or hold in most instances where common ownership is involved? At best, the answer is that we do not know.

In enacting the banking moratorium earlier this year as part of the Competitive Equality Banking Act, Congress wisely reacquired control over setting policy directions for banking organizations backed by federal deposit insurance and the federal safety net, and stopped bank regulators from continuing their undermining of the Glass-Steagall and Bank Holding Company Acts. Congress recognized that banks should not be permitted to speed into uncharted waters without thorough examination of the hazards involved.

SIA has long called for a thorough, objective comprehensive review of the relations between banks and other financial institutions. It has expressed its belief that such a review would reaffirm the wisdom of separating banking and commerce in general and banking and securities in particular. SIA still believes that such a comprehensive review is an essential prerequisite to any weakening of our present structures and hopes that Congress will conduct such a review.

With the expiration of the moratorium approaching, Congress must decide how to proceed in a safe and sane manner. It must not lose control over the setting of national financial policy that it has only recently reacquired in the Competitive Equality Banking Act. It should continue the comprehensive review that it is just beginning in a much more intensive and concentrated manner suitable for the complexity and monumental importance of the subjects under consideration.

Since CEBA was passed, intervening events have already demonstrated that Congress was right to halt the undisciplined expansion of powers of federally-supported bank and thrift organizations by federal regulators, state regulators and legislatures. Some might say that the recent turmoil in the financial markets suggests, if anything, that all statutory exceptions and regulator-created loopholes in the Glass-Steagall and the Bank Holding Company Acts that have permitted banking organizations to engage in some securities and other non-banking activities should be shut down -- that true protection of the federal safety net now counsels fewer, not more, non-banking powers.

At a minimum, the events of the last few months point up the complexity, fragility and unpredictability of the financial system, the interconnectedness of the risks inherent in it, and the need for circuit breakers in the system. We should all consider ourselves lucky that banks were not more heavily involved in the securities business when October 19 came around.

The possibilities of and the need for change can be explored consistently with the preservation of safety. However, the bills now before the Committee put the cart before the horse. Banks should not be granted further powers in risk-filled areas, on the basis of mere hope that a new, untested insulation system will prove an adequate replacement for the separation provided by the Glass-Steagall and Bank Holding Company Acts. Existing securities powers of banks, a growing cause of concern because of vastly increased market volatility, provide an excellent opportunity for examining the effectiveness of any Glass-Steagall substitute before it is strained by additional non-banking activities.

Congress has the time -- and the nation has the need -- for such a period of testing. There is no crisis in banking that new securities, real estate or insurance activities provided by banks are needed to solve. Despite the urgently-repeated demands of banks seeking to amend or repeal Glass-Steagall (and then the laws that keep them out of insurance and real estate), it is a fact that well-managed banks of the kind that are leading the charge to get into the securities business even further are making a more than adequate return in banking now. A cautious, measured step is the only sure step for Congress to take.

With all due respect for the sincerity of their sponsors, the three bills presently before the Senate Banking Committee are, in our view, headed in the wrong direction and are fraught with unnecessary risk for the banking system that has not been adequately considered and guarded against. The Financial Modernization Act and the Financial Services Oversight Act will both almost certainly involve a one-way street for banks to get into other peoples' businesses and thus are patently unfair. Adequate safeguards against extension of taxpayer risk and unfair competition from banks have not been sufficiently developed.

These are complicated matters that cannot be rushed. They must be analyzed carefully. Change for the sake of change is never wise. Congress should take whatever time is necessary to do the job right and should not let the hasty acts of regulators or state legislatures deter them from their leadership right and responsibility.

Banks are at the heart of our financial system. They extend credit to the other sectors of the financial world and the rest of commerce. Federal backing and the numerous other special advantages banks enjoy were conferred on the banking industry by Congress to ensure the good health of this vital organ so that the rest of the economic body would flourish. Congress did not intend these advantages or the risk to the federal safety net to carry over into bank participation in financial or commercial enterprises that can stand alone without government support. There was no need in 1933 to extend the federal guaranty beyond bank financial intermediation functions and there is no need for it now.

If Congress nevertheless wishes to consider eliminating the wall between banking and commerce in whole or in part, SIA believes a two-stage approach to be the wisest course. SIA, of course, believes that the wall should be maintained, that separation of ownership of banking and other functions makes the most sense, is the safest and assures the best chance of fair competition and diversity of choice. Further, if the wall exists, banks are more likely to concentrate on the role of banking for which they receive federal support than if they are allowed to divert their energies into other enterprises.

How should Congress proceed?

First, it should test whether an internal "firewall" can be created to segregate successfully existing non-banking activities, such as securities activities, from the rest of the banking organization. Existing securities activities can be used as the "test" activities. They are far from the humdrum activities they were when Congress allowed these "safe" exceptions for federal and state and local general obligation bonds and notes. Simultaneously with the wall being tested, the Congressional comprehensive review should continue. A detailed and thorough analysis should be undertaken, for example, to examine thoroughly the special implications and risks involved in corporate debt and equity securities and insurance underwriting for banks. All of the implications and desirability of mixing banking and commerce, in steps or all at once, need careful study. The questions of functional regulation, overseas and domestic risk management and regulation are just some of the items that need to be considered. The definition of "security" itself needs review.

Second, if the restructured banking organization with a firewall does in fact work, Congress may then proceed with confidence to consider the changes it wishes to make. It might allow some additional powers to banking organizations or it might conclude that banks can be affiliated with any kind of business enterprise. Properly prepared for, this all-at-once step clearly is the fairest of all, permitting all parties an opportunity to participate in all activities, with similar safeguards. Anything less constitutes an unfair advantage for banks by allowing them to invade the businesses of others, one business at a time, without allowing others to enter banking.

Of course, if the firewall does not work as effectively as hoped, no unfair competitive harm will have been done and no risk inadvertently added to the banking system. Why gamble? There is too much risk involved to gamble on what is not known when there is no compelling need to rush forward towards unexamined change.

The separation of banking and commerce is more than one hundred years old. The special subset of that separation known as the Glass-Steagall Act has been in place for more than fifty years. Whatever Congress does now can affect the financial health of the nation for decades to come. Therefore, Congress should satisfy itself that what it is planning to do will promote, not endanger, the safety and soundness of our banking system, the competitiveness and diversity of the American financial marketplace and the health of all of commerce. The complexities of the problem deserve no less. Congress has the chance to plan soundly and comprehensively. It should take it.

In addition to commenting on the provisions of the bills that are the subject of this hearing, this statement reviews some of the arguments and concerns raised in connection with the highly complex subject of allowing banks to engage in activities outside of banking in competition with businesses that do not enjoy bank advantages. SIA may have more to say. Therefore, SIA requests that the Committee leave its record open for a period of ten days from this date to permit it to supplement this statement with additional materials bearing on these proceedings.

II. THE FEDERAL SAFETY NET, TAXPAYER RISK AND UNFAIR BANK ADVANTAGE

SIA believes that any action by Congress should be consistent with a few basic principles to guide a consideration of the proper structure for the financial services industries in the United States. These principles promote important objectives and institutions: the system of separation of powers and prerogatives between the legislative and administrative branches of government; maintenance of the integrity of federally-insured depository institutions and limitation of taxpayer risk; conservative change and practicality in implementing new policies and structures; fair competition, both within activities providing financial services and between the financial services industries and other industries; the preservation of a competitive financial system; functional regulation of financial services activities; and careful consideration of a new framework for financial services and the complex issues that are raised.

A. Congressional Prerogative

Congress is the party responsible for determining a policy for financial services conducted by U.S. companies and banks. Beginning in 1981, at the onset of the Reagan administration, banking regulators and banks escalated their efforts to obtain new powers for banking organizations to carry on securities activities and other nonbanking businesses. The addition of new investment powers for the thrift industry has resulted in disaster. Bank regulators began making policy in these areas without benefit of Congressional direction. On their own, they helped their banks find and exploit loopholes in existing laws and helped their banks to exploit them. The "engaged principally" applications being seriously entertained and acted upon by the Federal Reserve Board are prime examples of how far afield regulators are wandering from clear Congressional intent. The Comptroller of the Currency's position that securitization of bank assets does not involve securities activities prohibited to banks under current law is another example.

A comprehensive review of all the laws that govern our financial services marketplace is needed. This is the essential first step which Congress should now take. SIA has called for such a review for years. We are grateful that it is at last underway. It should be conducted carefully as befits the complexity and importance of the questions examined.

The Competitive Equality Banking Act passed this year reflected, in major part, the concern of Congress with the usurpation of Congressional prerogatives by the banking regulators. To reacquire control over national financial policy, the Congress placed a one-year moratorium on regulatory expansion of bank powers in the securities, insurance and real estate fields. CEBA also provided for the recapitalization of the Federal Savings and Loan Insurance Corporation (FSLIC). FSLIC's insurance fund had been decimated by rescuing the thrift industry, which suffered losses attributable in no small part to its relatively recently expanded investment powers.

Congress should not lose control of the decision-making process. It should take whatever time it needs to decide these important questions. Congress should take advantage of this opportunity to exercise its responsibility in determining the proper activities for banking organizations and their relationship to nonbanking companies in the United States in its consideration of the appropriate structure for our financial services industries.

B. Containment Of Federal Backing Of Risk In The U.S. Banking System

A second important principle is the maintenance of the balance of risk within the U.S. financial system. The system has worked quite well since the passage of the Glass-Steagall Act in 1933. Today, the securities industry is a wide-open industry in which anyone with capital, talent and experience, except banks backed by the federal government, can enter -- and many try. In the securities business, capitalism operates well. The best can be successful and prosper while others might fail. We now have a securities industry which can handle any kind or size of transaction. It is intensely competitive. There are also growing pains and cyclical problems, to be sure, and a great deal of present nervousness and unrest due to the October collapse. Losses have been suffered; layoffs are spreading. There have been business failures and mergers. The risk of failure is always present and Uncle Sam is not there to pick up the pieces, nor should he be. The volume, volatility, complexity and risk in even everyday securities operations is astounding.

Behind the banking system, which is at the heart of our entire financial system and economy, stand the federal government and the American taxpayer. What began as deposit insurance only is now a web of government support of all banks, of banks that are "too big to fail," and, upon occasion, even of bank holding company families that are too big to fail. In enacting the Bank Holding Company Act of 1956, Congress recognized, as it did in passing the Glass-Steagall Act in 1933, that banks with the backing of the federal government play a paramount role in the nation's economy. For banks to compete with nonbanking companies and capitalize on the advantages conferred by the federal government is unfair.

Congress in 1933 was only interested in having the federal government back the core banking activities of banking institutions, not real estate development, securities activities or other risks not central to banking. As the Supreme Court analyzed it, Congress wanted a banking industry to be the sober, objective central supplier of credit to the economy, free and independent of the entrepreneurial and heavily profit-motivated urges of the rest of the financial world, the free market and the rest of commerce. The two roles were deemed to be incompatible.

Congress in those earlier days felt that the confusion of the two roles could only lead to a loss of the objectivity of the banking role and unfair competition. This is still the case. In addition, in the current financial environment, to succeed even moderately in the securities business increasingly entails great risk, far more than the risks Congress considered too dangerous for the federally-backed banks to be involved in 1933 or even in 1983. Over the past decade, the securities business has changed -- from one in which one major source of income was brokerage, or executing transactions, to one in which the major source of income is dealing, acting as a principal and taking positions in the market. Should the federal government now start backing risks across the entire range of the securities business and bailing out threatened failures? Most Americans would say no.

Since federal support is behind federally-insured banks and to some undefined extent their affiliates, it is essential that all units of a bank or thrift holding company, including federally-insured banks and thrifts and their subsidiaries, be governed by federal law insofar as the scope of their activities is concerned. In a bank or thrift holding company complex, funds generally flow freely among the components. As long as the holding company complex contains any federally-insured depository, it is therefore important to limit the risks to such insured depository institutions by limiting the activities of all of their affiliates, regardless of the authority granting the certificate of incorporation or charter.

C. Overseas Securities Activities

Overseas securities operations of U.S. banking organizations were not very significant in relation to U.S. activities when bank regulators first concluded that Glass-Steagall did not extend to them. However, with developments in the Euromarket and with increasing activity in Asia, there is an urgent need to examine the global non-banking activities, particularly the securities activities, of banking organizations, whether the location of the affiliate owned by a U.S. banking organization is inside or outside the United States. The scope of these activities has mushroomed. As a result, unwanted and unnecessary risk is presently being placed upon the federal safety net.

The argument is made that experience abroad of U.S. banking organizations in securities activities shows that broad securities activities can be authorized in the United States as well. But it is not convincing. Contrary to common belief, the securities activities overseas of U.S. banking organizations are quite restricted and the experience of U.S. organizations abroad is highly limited. Subsidiaries of U.S. bank holding companies and of U.S. banks, including Edge Act corporations, may underwrite abroad only up to $2 million of equity securities of an issuer without a binding commitment of other purchasers. Branches of U.S. member banks abroad are even more restricted in underwriting under Section 25 of the Federal Reserve Act and Regulation K, in that they may only underwrite debt securities of governmental entities in the countries in which they are located, and may not underwrite any equity securities. Thus, the experience of U.S. banking organizations in securities activities abroad is much more limited in risk-taking operations than banks would have us believe. Certainly, the extension of securities authority being proposed in these bills is far broader than any bank has experienced at home or abroad.

American banking organizations did not participate in the underwriting of the recent British Petroleum issue in the U.K. in which some U.S. investment banks lost tens if not hundreds of millions of dollars. It may be that worldwide securities operations of banking organizations, after appropriate examination, should be scaled back to what is permitted domestically. In any event, those operations should not be cited as positive reasons for expanding bank securities powers. The risks to the federal safety net and the fairness of competition with non-banking organizations must first be evaluated.

D. Sound And Cautious Consideration Of Change And Safeguards

There is a need for a cautious approach to consideration of new non-banking powers for the federally-supported banking industry. As Professor Lawrence R. Klein, Nobel Laureate in Economics at the University of Pennsylvania, has written, "We should move very cautiously in the direction of deregulation; to move too fast could be seriously destabilizing."[1] If Congress decides that it wishes to consider bank requests for changing the present system, it should proceed conservatively by first devising effective substitute structures to manage properly the risk and unfair bank advantage which can be involved in presently-authorized non-banking activities. If these new substitute structures prove to work in practice, Congress could then consider where next it should move. Only then will the complete abolition of the division between banking and commerce may prove to be practical.

However, such separation within a banking organization to minimize risk to the federal safety net from activities it was not designed to support is no sure thing. Nobody knows whether a wall can be built inside a banking organization that is strong enough to provide an effective substitute for the Glass-Steagall or the Bank Holding Company Acts. Congress did not think it could be done in 1933 when it ruled out common ownership of banking and securities firms.

The stakes are too high to gamble on what might work, but might not. Since some present securities activities of banking organizations are imposing unnecessary risk on the federal safety net and banks that engage in such activities are unfairly benefiting from their federal safety net connection, to the detriment of fair competition, these present risks and unfair advantages should be distanced from the federally-backed banking system as part of the experiment. In other words, before any consideration is given to granting new securities powers to banking organizations, a restructuring of banking organizations should take place as a test to see if the internal firewall can work. If the new structure -- based on an effective firewall -- works effectively to isolate banking from non-banking activities and if other policy considerations involved in the grant of additional securities powers to banking organizations are resolved favorably, expansion of bank securities powers could then be considered. Or, perhaps more fairly, consideration could be given to the complete elimination of the division between banking and commerce so that all parties would have the same chances to obtain prominence.

As part of these considerations, financial feasibility must be looked at. For example, there is a need for adequate capital both in the banking industry and in the securities industry. If bank holding companies are to allocate capital to back securities activities, there must be sufficient capital to support banks in their principal role of banker., Capital should not be used for non-banking activities to the detriment of serving business and the consumer with banking services.

E. Fair Competition

The maintenance of fair competition between banking organizations and other financial industries and the rest of commerce must be a principle for any reordering of the relationships of banking organiztions. Isolation of non-banking activities, such as securities activities, from the rest of the banking organization by a truly effective internal separation is essential to any effort to promote fair competition with firms whose resources are not enhanced by the federal safety net.

In considering whether additional powers should be granted to banks and what relationships depository institutions should have to bank holding companies that are engaged in nonbanking activities, Congress should focus on the advantages that banks have in using their special power and position as government-backed institutions in competing against others outside of banking. Banks are inherently unfair competitors outside of banking if, as is now the case, they can use their federally-derived banking relationships, credit sources and credit tools to promote their non-banking businesses. The situation will be made dramatically worse if bank non-banking activities are allowed to grow.

F. Limit Concentration Of Economic Power

The prevention of undue concentration of economic power must also be a concern of Congress. Indeed, the antitrust laws seek to prevent dominance in particular markets to promote consumer welfare and a more efficient economic system.

Banks as sources of credit will, in time, dominate whatever market in which they are allowed to compete. For example, banks now routinely leverage their credit enhancement facilities to obtain positions as managing underwriters in bond syndicates in which they are eligible to participate, despite the existence of anti-tying statutes. There are ample reasons why banks should not be permitted to engage in such non-banking activities. But to the extent they are allowed to do so, Congress must exercise its best efforts to reduce their unfair advantages. It is clear that generalized prohibitions that are impossible to police, such as "arm's length" dealing requirements between banking and non-banking operations of a banking organization, will not do the job. What is needed are self-operative prohibitions that preclude banks from utilizing their huge asset pools gathered under the aura of government support, their credit facilities and other advantages, such as peculiar accounting rules and access to the Federal Reserve window and payments system, to undercut other participants in non-banking businesses.

G. No Unfair Benefit To One Industry Over Another

Congress should promote competitive fairness as part of its financial policy. Bills that facilitate bank entry into other businesses, without a reciprocal right of entry, even with the best limitations possible on unfair dealing, will undoubtedly benefit the banking industry over the industry affected. There is no practical way short of full repeal of the division between banking and commerce for securities firms to enter the banking business. Legislative proposals that do not permit reciprocity as a practical matter are unfair. In such cases, the need for strict isolation of non-banking activities is extremely high and may be unattainable.

H. Functional Regulation

Functional regulation is an important principle to assure equality among competitors. Therefore, in the case of the securities business, all securities business presently carried on by a bank holding company complex should be isolated in a securities affiliate of the holding company and subjected to the same regulation as is required of a securities firm. Any securities affiliates of bank holding companies should be regulated by the Securities and Exchange Commission (SEC) and the other organizations that are involved with the securities industry. All the rules, including tax and accounting rules, should be the same for securities affiliates as for securities firms, and the enforcer of those rules should be the same. Special accounting rules for banks that allow unrealistic values to be assigned certain assets should be eliminated.

I. Comprehensive Evaluation

A final principle that should guide Congressional consideration of what the structure and relationships in the financial marketplace should be is the necessity for a comprehensive examination of all of the problems, needs and possible alternatives for the functioning of the marketplace and service to business and the consumer. The recent decline in the stock market has led to a call for several studies whose results may be informative regarding the interrelationships between trading markets, the payments system, banking organizations and securities companies.

Congress should, for example, undertake a detailed review on its own of the implications of further expansion of bank securities activities for risks, competition, concentration, and control of financial institutions before considering any further steps into underwriting of corporate debt and equities. While there has been discussion for years about whether or not banks should be allowed to underwrite commercial paper, mutual funds, mortgage-backed securities and municipal revenue bonds, there has never been any similar detailed examination of the implications for control of American business by banks if banks were to be allowed to underwrite corporate debt -- including junk bonds -- and corporate equity. The risks and conflicts related to bank underwriting of corporate securities have not been probed by Congress since 1933, years before many of the contemporary financial instruments that increase market volatility were created. The need for careful consideration has been emphasized by Professor Lawrence R. Klein. He is afraid that the pressures for expanding bank horizons will cause the following important questions to be overlooked:

> 1. "What are the first priorities for banks, to serve primarily the interests of depositors or of stockholders?"
>
> 2. "Do we need financial giants in order to compete?"
>
> 3. "Is it not better to let bankers be bankers, security traders be security traders, insurers be insurers, investors be investors, etc.?"
>
> 4. "Will not the incidents of bad judgment have far more serious repercussions if made by the office[r]s of large conglomerates than if made by heads of smaller specialized firms?"

The import of these questions, that banks should not put other peoples' money at undue risk, that there is a role for well-run U.S. enterprises that are small or medium-sized and run intimately by owner-managers and that leaders of conglomerates lose masterly control of the separate parts, is shared by SIA.

* * * * *

If Congress observes these nine principles in considering changes in the framework for the financial services marketplace, it will be acting wisely. SIA agrees that the present loophole-riddled legal situation requires some change now; it disagrees only on the direction of that change, and is skeptical about moving away from the separation of banking and commerce and banking and securities to some internal firewall that might not work. The only correct course is to retain control over the setting of national financial policy in Congressional hands, to test the internal firewall concept first by isolating all present securities activities within a completely segregated bank holding company subsidiary and observing it in practice while exploring all of the policy questions involved. If the concept does not work out as well as hoped, no harm will have been done and some risk to the federal safety net and unfair bank competition may have nonetheless been reduced.

III. HOW HAS THE DIVISION BETWEEN BANKING AND COMMERCE WORKED?

A. Glass-Steagall Is Still Needed

Some would have us think that it is time to relegate Glass-Steagall to the dustbin of history. Recent events suggest that those who enacted banking legislation in 1933 were more visionary than anyone could have imagined.

A full review of the legislative history of the Glass-Steagall Act is beyond the scope of this testimony. However, the concerns that resulted in the enactment of the Glass-Steagall Act are not time-bound and archaic. They were the inevitable pressures and conflicts that result from the combination of commercial and investment banking. Might they arise again should a recombination be effected today? Consider the words of Senator Bulkley, a member of the Senate Banking and Currency Committee, who addressed the Senate on the provisions of the Act:

> Can any banker, imbued with the consciousness that his bond-sales department is, because of lack of securities for sale, losing money and at the same time losing its morale, be a fair and impartial judge as to the necessity and soundness for a new security issue which he knows he can readily distribute through channels which are expensive to develop but which presently stand ready to absorb the proposed security and yield a handsome profit on the transaction?

75 Cong. Rec. 9911 (May 10, 1932).

Those who enacted the Glass-Steagall Act realized the impartial allocation of credit and a consequent safety of deposits would be compromised if banks were to enter the securities business. In the words of Senator Bulkley:

> The banker ought to be regarded as the financial confidant and mentor of his depositors. . . . Obviously, the bank who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an

> underwriting profit or a distribution profit or a trading profit or any combination of such profits.

75 Cong. Rec. 9912. His conclusion was unequivocal:

> If we want banking service to be strictly banking service, without the expectation of additional profits in selling something to customers, we must keep the banks out of the investment security business.

Ibid.

The solution proposed was to divorce two forces that could not be safely combined. For if

> the business of originating and underwriting investment securities is confined to houses not engaged in deposit banking, then the extent and the desirability of new issues will be subjected to an independent and impartial check.

Ibid.

Concerns regarding the fair allocation of credit and conflict of interest are not the only concerns relevant to today. The prescience of those who drafted this legislation is illustrated vividly by the recent tumult in the equity markets. Quite simply, we are all very lucky that the two cornerstones of the 1933 banking legislation, federal deposit insurance and the separation of commercial and investment banking, were in place during the momentous market collapse that occurred this past October.

At the risk of repeating figures that we have all heard too often, in one single day $500 billion in value was wiped out. The Dow Jones Industrial Average lost 22.61 percent of its value in one day alone.[1] The fall of non-Dow stock was even more devastating. Yet, despite the panic that swept through the equity markets, there was no run on the banks, because our banks were not in the game. The portfolio losses that hurt banks in the 1930s and helped plunge so many into insolvency were not a concern on October 19. No repeat of the wave of bank collapses that punctuated the early 1930s was experienced or even seriously feared.

The protective role Glass-Steagall played by in this process cannot be emphasized enough. As Martin Mayer recently wrote, "the banking legislation of the 1930's is not a Chinese menu that permits choices from column A and column B. It is a relatively unified body of law, more tightly written and more directly expressive of its intentions than most of what gets written these days. . . . For sure, the country can't afford . . . the repeal of Glass-Steagall without at least some modification of deposit insurance."[1] None of the proposals on the table has sufficiently addressed the increased risk to the system which expanded bank powers will pose. To be sure, someone will end up insuring the banks' foray into the markets; the taxpayer will ultimately be called upon to finance bailouts.

Even bank regulators recognized that limited bank exposure to the equity markets was a blessing. The Comptroller of the Currency reminded everyone in the aftermath of the crash, "It is important to remember that banks do not invest in equity securities. . . . As a consequence, the stock market drop should not affect banks' investment portfolios."[1] What might the crash have been like if the Comptroller's statement could not have been made?

The market collapse is not an isolated event. The crash was emblematic of a new volatility that has taken over the markets. A recent study by the Bank for International Settlements noted, "It is generally accepted that volatility of exchange and interest rates has increased in recent years, both in day-to-day movements and over the course of the business cycle."[1]

The Wall Street Journal on December 1, 1987, listed the ten largest drops, by points, of the Dow Jones Industrial Average. Eight out of ten have occurred since October 6, 1987. All have occurred in the last eighteen months. Traders experienced enormous losses in the mortgage-backed securities market this past spring. One trader at Merrill Lynch was responsible for $275 million in losses in a matter of days. Risk has been bundled and rebundled until professionals thought that it had been bundled away. Many thought that hedging had made the markets safe. How surprised experts were when two new techniques, portfolio insurance and program trading, combined to exacerbate the markets' downturn. Anyone seeking to formulate responsible policy in this area must ask themselves: Do we want federally-insured banking organizations subject to the risks of these volatile markets? Junk bonds and equities cannot be hidden in a fixed-income portfolio until maturity; the day of payment may never come.

The Glass-Steagall Act has served the country well. It has brought us over 50 years of banking stability and open, free, vibrant, diverse, highly competitive capital markets and an economy free of domination of large banking institutions. It has continued to provide the stability it conferred upon the banking system upon its enactment. As one newspaper recently pointed out in an editorial, reprinted as Appendix III-B-7(2), in 1930, before the present banking legislation was passed, 1352 banks failed, by one count. In 1934 after the passage of the Act only 57 failed, by one count.[4] The American banking system continues to be a source of bedrock stability for our financial system. Before we change fundamentally the laws that have given us this stability, we must make a sober assessment of the arguments that banks advance in favor of such change.

All of the impetus for change is coming from banks, their regulators and their friends. Their arguments for change must be closely examined. As The Christian Science Monitor said in the editorial referred to above, "The burden of proof must be on the proponents of repealing Glass-Steagall. Unless the reasons prove to be decisive, the law, which has safeguarded the American people for more than half a century, should not be altered."

B. Bank Need For Non-Banking Expansion Not Shown

Those who would modify or repeal Glass-Steagall or the Bank Holding Company Act argue that banks need to expand into new areas to compensate for losses in their traditional lending roles. The data available suggests, however, that both the ill-health of the banking industry and the benefits to it of entry into other areas of operation have been overstated. There is no indication whatsoever that the banking industry is in such a state of distress that it needs additional powers in the immediate future to survive. Absent such indications, one must question why a system that has kept banking safe and sound for over half a century should be dismantled to any extent -- much less why banks should be granted full securities powers, including corporate debt and equity -- without first trying out a substitute structure to see if it will work before adding more risks and conflicts to the banking system.

1. Bank Profitability Is Not Declining

Banks certainly need to make a profit to stay healthy and to continue their central role in the economy. Such government-supported institutions, however, need not become the richest companies in the land. If there were a sustained, dramatic across the board decline in bank profitability, it might well be cause for concern. But that is simply not the case.

Former Federal Reserve Chairman Paul Volcker testified in June, 1986 in favor of granting banks limited new securities powers rather than permitting them full entry into securities or other non-banking activities. According to his testimony:

> [T]he ability of the banking industry to build reserves and capital and maintain profitability does not suggest an irreversible loss of competitive strength. There are other indicators of underlying resiliency: for example, apart from one data series heavily weighted with some large troubled banks, most indexes of bank stocks have performed as well as or better than broader stock market indicators thus far this decade. . . . Net returns on assets of the largest banks have remained within historical ranges despite record loan loss provisions. . . . It is also significant that large regional banks, as a group, recovered so well [in 1985] that measures of their profitability now equal or exceed recent peaks. In sum, the data . . . do not support an assumption of irreversibly declining bank profits (emphasis added).[1]

Despite the trends to securitization and junk bond financing, all large banks (banks with assets over $1 billion), excluding the nine money center banks, had their 15-year high return on equity in 1985. The top money center banks did not do as well, principally because of increases in their loan loss provisions due mostly to setbacks in overseas activities. When data from certain money center banks that experienced exceptional losses is excluded, even the money center banks have shown no significant decline in return on equity.

There are other indicia that the American banking industry is healthy. For example, the profitability of U.S. banks compares favorably with banks located in major industrialized countries. In 1986 Citicorp had more than twice the profit of Japan's biggest bank Dai-Ichai Kangyo. Chase Manhattan and Morgan also had better profits than Dai-Ichai. According to a study of bank profitability conducted by the Office for Economic Co-operation and Development, the average profit after tax for U.S. commercial banks during the years 1980-1985 was, by a wide margin, the highest among industrial nations. A chart detailing the OECD's findings is attached to this statement as Appendix III-B-1(I).

While it may be true that banks have lost some of their short- and middle-term credit to commercial paper and securitization, their overall share of the lending business is increasing. In fact, the banks' share of credit extended to domestic nonfinancial businesses during the years 1982-1986 exceeded on average that of the preceding two decades. Moreover, as indicated by the data attached as Appendix III-B-1(II) and III-B-1(III), the interest rate margins of U.S.

commercial banks improved throughout the 1980-1985 period, a phenomenon shared by the commercial banks of only four other major industrialized countries, and have remained steady or increased over the period 1970-1985. During the period 1984-1986 alone, average annual net interest income for the group of U.S. banks listed in Appendix III-B-1(4) increased by 28.3 percent. Such data demonstrate that lending remains a good profit center for banks. According to the Federal Reserve Bank of New York's 1986 study of recent trends in commercial bank profitability:

> One striking fact is that despite all the structural changes relating to interest rates and interest rate competition of recent years, there has been no visible impact on the net interest margins of the banks. . . . [N]et interest margins show no sign of long term deterioration for any category of banks. Indeed, there has been at least some increase in these margins for all bank size groups since 1978, the year in which the first floating rate consumer certificates of deposit (CDs) were introduced.[1]

Significantly, the most profitable banks in the United States are the super-regionals, which largely work in their traditional role as intermediary.

A comparison of return on assets (ROA) and return on equity (ROE) for the years 1975 and 1985 shows that average ROA increased from .69 to .70 over that decade for all insured U.S. commercial banks, while average ROE declined only marginally from 11.8 to 11.4. Of course, there have been downturns and upturns in the financial fortunes of select sectors of the banking industry over the past decade, as there have been in every industry. But on an industry-wide basis, there is simply no cause for alarm. Indeed, an examination of the performance of some of our well-managed banks which avoided the siren song of high-interest lending to developing countries shows marked improvement over the past ten years.

Therefore, a principal argument of banks for being allowed to take on more risky activities, the supposed lack of profitability in the banking business, just does not hold up.

2. Additional Powers Would Not Materially Increase Bank Profitability

Even if long-term declines in bank lending activity profits were manifest, which they are not, entry into additional financial activities which banks seek to access, such as securities activities, would have minimal impact on those profits.

The Federal Reserve Bank of New York's 1986 study of recent trends in commercial bank profitability confirms that bank expectations for increased profits in non-banking operations in general, and securities operations in particular, are inflated. According to the report,

> [W]hile individual banks could enhance their profitability (at least over the long term) by entering new securities activities, the profit impact for the banking industry as a whole would appear to be small in view of the relative sizes of the banking and securities industries. Equity capital in the entire securities industry was only $12.8 billion at year-end 1984, less than a tenth of the banks' $143.4 billion in equity. If, in a somewhat fanciful scenario chosen to accentuate the point, the banking industry were to raise $12.8 billion and earn the securities industry's normal return thereon, its consolidated ROE would increase only by a modest amount even without considering start-up costs, competition with existing securities firms, and less than a complete takeover of all securities activities. These factors, of course, would reduce the expected return to the industry. Alternatively, to avoid these start-up costs and inter-sector competitive effects, banking organizations could seek to acquire existing securities firms. In doing so, they would have to pay some premium over the market value of the target firms, which typically runs between book value and twice book value. Any premium over book value will automatically dilute the earnings to be obtained from the acquisition, as the earlier examples demonstrated. Consequently, in the short-term at least, it appears unlikely that any significant industry-wide improvement in ROE would result from the absorption of the securities industry by the banking industry.[1]

Indeed, according to a recent study, the after tax profits for all New York Stock Exchange member brokers in the years 1973-1984 was only 6.7 percent of the after tax profits of all insured commercial banks during that period.

Recent developments in the securities industry can only bolster that conclusion. The Tax Reform Act of 1986 has sharply reduced underwriting volume and profits in the tax-exempt area. Salomon Brothers, the volume leader in the municipal obligations sector, recently shut down its municipal operations. Several other municipal securities firms have likewise fallen victim to reduced profits, and many remaining firms have had to cut back. Corporate debt issues and stock offerings have also seen dramatic reductions in volume in the aftermath of the October market collapse. The bull market years without question have been generally good ones for participants in the securities business, but it has never been the case, and is certainly not the case now, that profits are guaranteed. There is a volatility in profits in the securities industry to which federally-backed banks and their insured deposits should not be exposed.

As Appendix III-B-2(1) shows, during the period 1973 through 1984, the after-tax return on equity for the securities industry swung wildly from 26.6 percent to a 3.0 percent loss, while the after-tax commercial banking ROE remained within a stable range of 13.90 percent to 10.68 percent. Securities firms failed by the hundreds and thousands lost their jobs. Quarterly figures reveal even greater volatility; annualized quarterly returns over the 1979-1984 period for the securities industry ranged from 41.3 percent of equity to a loss of 1.8 percent, as indicated in Appendix III-B-2(2).

It is unlikely in any event that additional securities powers for banking organizations would help those banks with significant profit declines in recent years. The declines in return on equity and return on assets have been sustained primarily by banks with assets or equity under $100 million. These are not prime candidates for significant involvement in securities activities.

Ironically, the assertions by the sponsors of the bills before the Committee that banking organizations need a piece of the securities pie to shore up declining profits on their traditional lending activities are made side by side with claims that the full entry of banks into securities activities will cut profits in that financial sector for the benefit of issuers. It is difficult to envision how banks can be saved by securities activities profits while at the same time being the price-beating saviors of the issuers.

Therefore, the benefit to banking organizations from increased securities activities appears not to be great. They would become involved in a tremendously volatile, cyclical and risk-filled business; they would quite possibly add risk to the federal safety net and because of their bank advantages be an unfair competitor: adding all of these factors up, the case for banks obtaining more securities powers is not made.

3. Diversification Of Depository Institutions Into Securities Or Other Non-Banking Activities Historically Has Weakened Banks And Thrifts

The saying that those who ignore history are condemned to repeat it includes banks and bank regulators. Banks argue that they need additional securities and other non-banking powers to compensate them for diminishing short and intermediate loan portfolios. This identical argument was made in the 1920s, when banks pointed to declines in their commercial loan portfolios as a principal reason for their need to engage in the securities business.

The consequences are well known. In the aftermath of the enactment of the McFadden Act, which removed existing restrictions on securities activities by bank affiliates, originations of new issues by banks increased from 22 percent of total originations in 1927 to 44.6 percent in 1930. By 1930, the rush of banking organizations to diversify into allegedly more profitable securities activities had resulted in a doubling of their risk exposure in that financial sector in a mere four years.

Bank failures increased proportionally during those years. In 1929, there were about 650 bank failures, and during the following year 1350 banks failed, culminating in the failure of the Bank of United States and the loss of over $200 million of deposits in 1930 dollars, a loss that was widely perceived as attributable to the bank's securities activities. The Glass-Steagall Act, passed in 1933 in response to this spate of bank failures, reinstated the barrier between commercial banks and securities firms; by 1934, the annual bank failure rate was under 60 banks.

Half a century later, history did indeed repeat itself. This time it was the savings and loan industry that claimed a need to expand from its traditional mortgage lending activities because of rising interest rates. The promised land this time was direct investment in real estate. State laws and federal law facilitated this movement. Hundreds of federally-insured S&L's became affiliated with real estate development firms in the early 1980s. We all know the result. Over ten percent of S&L's are now insolvent, FSLIC is broke or near-broke, even with the recent infusion of cash, and $23.5 billion is needed just to sell the institutions FSLIC has identified as terminal. Where all the cash will come from is anyone's guess. Increasingly, the guess is that it will come from the taxpayer's pocket.

Some will argue that there were special factors that account for these past disasters associated with expansion of depository institutions into non-banking operations. The claim is made, for example, that disclosure laws, the creation of the SEC and other regulatory controls established since the 1930s make a recurrence of the bank failures of that period unlikely. But regulators are already strained beyond their capacities. In an era of budget cuts, the salaries and experience of regulators are not keeping pace, while turnover increases. Adding to the load of bank regulators or securities regulators the burden of supervising additional securities or other non-banking activities of bank organizations would simply exacerbate the problem.

And, of course, capital adequacy for our largest banks may be a problem. While loan loss reserves were increased recently with respect to developing country loans they represent about half or less of the estimated market value of these loans, about 25 percent of principal. German banks, for example, reportedly have reserved for between 60-70 percent of similar loans. The securities business has a voracious need for capital. Banks should not divert capital from their principal business of banking if it is needed there.

Congress should not allow the mistakes of the 1920s and the early 1980s to be repeated. There is enough burden on the federal safety net now. The arguments of the banks for more securities powers do not stand up and are no reason for imposing more risk on the American taxpayer.

4. The Globalization Of The Financial Markets Is No Reason To Expand Bank Powers

Banks argue that the increased globalization of the financial markets necessitates the expansion of bank powers. The argument is basically that capital can now flow from market to market and the flow will be dictated by the relative efficiency of each market. If U.S. markets are shunned because of excessive regulation, the argument goes, capital formation will occur elsewhere to the detriment of our domestic markets.

The flaw in this argument is that the relative attractiveness of our capital markets is not the only goal, or even the most important goal, of a rational system of regulation. Safety and soundness of the core of our financial system, namely, the banking system, is one of our important goals. If the only standard that guides our policy is what will make our markets most attractive, we will end up in a race to the bottom with the winner being the nation which has managed to create the unsoundest system of all. The federal safety net will be extended in its risk coverage and support underwriting and dealing in securities in the name of increased competition and lower underwriting spreads. However, the nominal savings that may accrue may well be lost as risk doubles back on the system in the form of bank failures which must be financed by the federal government and the taxpayer.

The globalization of markets means that all markets are now interconnected. The crash in the equity markets in October was a world-wide phenomenon as the charts in Appendix III-B-4-I show. Decisions made in the United States have ramifications for the world markets. Globalization has just increased the conductivity of risk. We must examine how to prevent failures in one market from automatically being transmitted to another market. One of the circuit breakers in our financial system is the Glass-Steagall Act in the United States and its equivalent in the other great market of the world, the Tokyo market. Risks from the capital markets are borne directly by the securities industry, but only indirectly by our federally-insured banking industry. That is the way it should be.

The experience in the London market illustrates the effect of homogenization of the financial markets. Firms rushed in to expand their capabilities and take advantage of the new environment. But as margins were squeezed and the return became far smaller than the risk justified, firms began to contract. The anniversary of the Big Bang was not a time for celebration in the London market. Firms marked the anniversary by cutting back their operations.10/ Before exposing our banking organizations to the turmoil and risks of greater securities involvement, we must be sure we can protect our core banking system safely. Is there a substitute for Glass-Steagall that will work? Why do we need a substitute for something that can work well now?

Banks point to the Euromarkets as an indication that banks may safely underwrite corporate securities. However, this comparison is illusory. As noted previously, the restrictions imposed by Regulation K are so stringent that underwriting abroad is a far different proposition than is advertised. In addition, even if the comparison does hold, the less constrained environment that prevails in the Euromarket may buy increased competition at a heavy price:

> While experience in the Euromarkets may not be conclusive, it does suggest that domestic markets with heavy bank participation will not necessarily contribute to more economically productive credit allocation or encourage institutions to exercise a greater degree of impartiality in making credit decisions.11/

The major result of the globalization of the financial marketplace is that now the system is far more interconnected than it has ever been. The result is that a crash on the Tokyo market immediately translates in to a crash on the American equity markets as capital is drained by foreign investors to meet the crisis at home. Hence, globalization raises the stakes for everyone and only increases the need for safe and sound banking policy domestically and internationally. The system needs more, not fewer, "disconnects," like Glass-Steagall.

5. Removal Of Glass-Steagall Is Not The Solution: The Example Of Japanese Banks

The banks' argument that the removal of the Glass-Steagall barrier is necessary to increase their competitiveness is belied by the Japanese banking system. Japan has its own wall between commercial and investment banking which, if anything, is more solid than the Glass-Steagall Act. Yet Japanese banks have done well by many standards. A report on the Japanese banking industry produced in November 1986 noted:

> Five of the world's ten largest banks based on year-end 1985 total assets were Japanese institutions. . . . At present, Tokyo holds the position as the world's second-largest financial market. At the same time, the city generates the world's largest flow of capital exports -- amounting to approximately US $50 billion in 1985. In the overseas markets, such as the United States and the United Kingdom, Japanese banks represent the largest single foreign segment. In fact, the Bank for International Settlements reports that the Japanese banks accounted for 25% of total international assets in late 1985, edging ahead of U.S. institutions for the first time.[11]

One wonders how anyone can claim that Glass-Steagall inhibits international competitiveness when the two countries that separate commercial from investment banking have the most powerful commercial banking sectors in the world.

6. The Market For Bank Services Is Huge

Banks in effect complain that the world has not stood still for them. But markets are always in flux. This is true for the securities industry, the steel industry and the shoe industry as well as for banking. A lot of the change is good, natural evolution. For example, banks point to the loss of their largest blue-chip customers to commercial paper, but such blue-chip businesses have been able to reduce their borrowing costs, with a consequent gain in efficiency and the ability to sell their products and services at lower prices. Is that bad? The consumer benefits.

In addition, to the extent these corporations have learned to lend to and borrow from each other without relying on the quasi-governmental banking industry and its federal safety net to provide the resources for their borrowing, risk to the system and to the American taxpayer is reduced and banking organizations have the opportunity to use their resources to assist those who truly need their federally-backed assistance through intermediation. Banks also complain about the increased financing of automobiles by automobile companies. Neither the shift to securitization nor the increase in automobile company financing is an argument for banks to abandon their government-supported role of intermediation or a reason for banks to enter the securities business or the automobile business.

Intermediation is an essential function in our economy. Only a very small percentage of American businesses can qualify for investment-grade ratings on their obligations. While a few of the rest may be able to issue so-called junk bonds, the vast majority need a bank as an intermediary, counselor and wise head when things get rough. That is what the basic federally-backed banking role is for, and it should be a cause for rejoicing if certain businesses can "graduate" from needing that kind of assistance. There is no shortage of customers to which only government-backed banks can cater.

For this reason, it simply is not the case that banks are being pushed out of their traditional lending activities by commercial paper and securitization. As noted in a recent Congressional Research Services report, "there is little evidence that banks have lost much of their market share. Commercial banks, including the applicants for extended banking powers, possessed a share of domestic financial private debt that was about unchanged on balance between 1974 and 1985."[11]

7. Capital Markets Risk Is High

(a) Introduction

SIA has always argued that the securities industry entails great risk. This is not to say that commercial lending is not risky, but rather to argue that there is no need to enlarge the circle of risk supported by the federal deposit insurance system. There are basic banking functions which banks should be carrying on that need and deserve the backing of the federal government. That is why the federal government stands ever-ready to save banking organizations. All would agree that the federal regulators and their insured funds should keep the banking system operating in the farm and energy areas. There the banks are acting in their irreplaceable role of intermediary: someone who tries to be a fair and objective lender, who makes a good and important loan and then stands by to help out during times of economic adjustment or personal difficulty. That is risky business by any standard, but an essential one that would not otherwise be carried out, and that is what the federal safety net is for.

The entrepreneurial risks of the capital markets are different. They are not directly backed by the federal government, nor should they be. Securities firms do lose money, but the government does not bail them out. Before granting banks new securities powers, Congress must consider why it needs to provide federal support for securities activities that to this point have stood or fallen on their own.

(b) The October Downturn

Any structure that Congress considers must be able to weather the bad times as well as the good. On October 19, 1987, the stock market suffered its largest loss in history as the Dow Jones Industrial average fell 508 points, dropping 22.6 percent, or nearly double the 12.8 percent plunge of October 29, 1929. Investors lost more than $500 billion in stock market value.[14/] Since 1948, there have been ten major market declines. The largest drop before October 19 was from December 1972 to September 1974, 46 percent.[15/]

Nevertheless, there was no run on the banks in October, in part because, as noted before, the Comptroller of the Currency, one of the proponents of giving banks new powers, stressed at the American Bankers Association convention in Dallas, "It is important to remember that banks do not invest in equity securities." If, as a regular matter, banks were investing and dealing in equities and corporate debt, including junk bonds, would the public have been as calm on October 20? Would the banking system have felt the direct effects? Would the federal safety net have been called directly into play to save some banks? Luckily, we may never know the answers to these questions.

The Comptroller's statement is ironic in the wake of the First Options' illegal bailout by Continental Bank. Continental Bank, the recipient of the largest bank bailout in history, $4.5 billion, bought First Options, an options clearinghouse, in 1986 for $135 million. According to the Wall Street Journal, "The firm was backing traders engaged in risky strategy -- selling so-called naked out-of-the money put options -- that brings steady profits in a flat or rising stock market but can result in almost unlimited losses when the market fails."[16/]

The reason Continental Illinois could own an entity engaged in this risky, securities-like activity in the first place is because the Comptroller of the Currency has ruled that trading options does not constitute securities underwriting. On October 19, when the stock market crashed, Continental Illinois National Bank tried to keep its affiliate, First Options, afloat. To do so, the bank made loans to First Options in excess of the legal limits, despite the fact that sixty percent of the holding company's stock is held by the FDIC.

In a twelve-page white paper written by Continental Illinois entitled, "First Options of Chicago, Inc., and its Relationship with Continental Illinois National Bank and Trust Company of Chicago," dated November 5, 1987, the bank explains its actions as follows:

> To understand why First Options suffered the loss it did, it is necessary to understand how it built its credit control systems. In building these systems, First Options had to develop a "worst case" scenario, just as an engineer considers a "worst case" earthquake or level of wind when designing a building. Similar to virtually every investor in the market, it looked to the worst day in the stock market's history, October 28, 1929, when the market dropped 12.8 percent, as the worst case for the future. Until the events of October of this year, virtually no reputable economist or business person thought that the events of October 1929 could be repeated in today's closely regulated securities markets, let alone exceeded. First Options' controls were designed to protect it in a worst case stock market drop of 50 percent greater than that of October 1929. However reasonable this might have seemed prior to October 19 of this year, on that day the market dropped nearly two times as much as in 1929.

As this near-perfect, textbook example shows, it is precisely because one cannot predict the risks of securities trading that federally-backed banking institutions should be kept away from the fluctuations of the securities markets.

(c) The Municipal Market

Just last Friday, December 4, 1987, The Wall Street Journal included two articles describing the much-publicized recent downturn in the municipal bond industry. An excerpt from one of these articles is included as Appendix III-B-7. The articles explain that, until recently, the municipal industry was booming. A number of factors, however, including the Tax Reform Act, the 1983 default of the Washington Public Power Supply System ("WPPSS") on $2.2 billion of municipal bonds and the stock market crash have radically changed the market. The trouble really began last spring, when bond prices dove 13 points, a decline in value of almost $130 on each $1000 bond in a market where a change of a half-point a day is considered significant.

A number of firms have left the business entirely. The largest house in the market, Salomon Brothers, which accounted for ten percent of the new municipals brought to market,[17] left the market on October 12, 1987. In addition, L.F. Rothschild Holdings Inc., stung by a $44 million trading loss in stocks, announced on October 26 that it would stop underwriting municipal bonds. Sixty-five of the 150 Rothchild jobs eliminated came from the municipal finance department. Kidder Peabody & Co. has laid off 100 employees and recently announced that it will slash 1,000 more jobs from its municipal bond staff. E.F. Hutton, before being acquired by Shearson, closed its bond underwriting and trading departments in several regional offices.[18]

The entire municipal market is extremely volatile now. General obligation bonds are still safer long-term investments because they are backed by taxing power, while revenue bonds are not. The only major default of municipal bonds in recent years involved the WPPSS revenue bonds. Adding these risks to the banking system without reorganizing the system first should not be done.

(d) Mutual Funds

After the crash, mutual funds fell as well. As The Washington Post reported in October, during the past few years, mutual funds have experienced tremendous growth and have outperformed many other kinds of investments. "In 1986, the average fund yielded a return of 16.2 percent, far above the less-than-6 percent return of money-market funds. Only the stock market as a whole did better than stock market mutual funds last year."[19] Nevertheless, as The Washington Post explained, "unlike insured deposits in banks, money placed in mutual funds is entirely at risk; if the stock or bond markets fall far enough, a mutual fund investor can lose his entire investment. This has happened during past market slumps, but mostly in isolated cases."[20]

But as a result of the October 19 crash, Fidelity Magellan, the largest stock mutual fund that had assets of $10.1 billion at the close of business on Monday October 19, had $10.7 billion on Friday October 16. The $600 million decline -- 5.6 percent -- was due to a combination in the fall in the stock market and a decline in the number of fund holders.[11]

The Comptroller of the Currency, on October 15, 1987, sent an advisory letter to an unnamed national bank warning it to diversify its portfolio and not invest solely in mutual funds. Robert Herrmann, senior deputy comptroller for bank supervision policy, warned that government securities funds are not risk-free investments, and that heavy concentrations of mutual fund investments "may expose banks to excessive market risk." Unlike losses from bond depreciation, "there is no assurance that net unrealized losses on mutual fund investments will ever be recouped, even if mutual funds are held for an extended period of time."[11]

(e) Existing Securities Activities

Bankers pushing for new securities powers, particularly the authorization to underwrite municipal revenue bonds, often argue that the Glass-Steagall Act does not authorize banks to underwrite municipal revenue bonds solely because such instruments were all but unknown in 1933. On the other hand, one could argue that in 1933 the current astronomical U.S. deficit was also never envisioned by those who enacted Glass-Steagall. At the beginning of President's Reagan's first term, the deficit was $1 trillion and over the past seven years, it has increased to over $2.4 trillion. These deficits are financed by U.S. Treasury bonds, and the exponential increase in volume of these securities, as well as the increased volatility of these markets, have resulted in subjecting banking organizations to levels of risk not dreamed of in 1933. The federal safety net is exposed to a huge amount of risk from these once safe activities. In reviewing the financial services industry, Congress may want to consider whether this increased volume of risk should be supported by the federal safety net or whether it should be separated from federal backing.

(i) Bond Market Speculation

Banks, large and small, have increasingly entered the business of speculating, particularly in the bond market, with disastrous results. American Banker on November 6, 1987 reported that bad gambles on interest rates by rural banks resulted in four bank failures and several near misses. Specifically, the November 6, 1987 issue of American Banker described recent losses at the First National Bank of Wilmont in Minnesota, which borrowed to buy about $11 million worth of long-term government and strip bonds:

> When the bond market tumbled, the bank was forced to put up more collateral on its margin

> purchases. In mid-May, federal regulators ruled that the bank was trading securities, not holding them for investment. As a result, the bond portfolio had to be carried on the bank's books at market value, rather than face value. Once the portfolio was marked to market, 'the capital accounts fluctuated on a daily basis like we were in Reno,' said Mary Curtin, a bank attorney representing the three former owners of the bank. 'We were getting quotes each day on how much capital we had.'
>
> When the bank closed shortly afterwards, its $1.2 million in capital had evaporated after losses of $1.75 million from trading.[11]

Other losses, according to American Banker, occurred at the State Bank of Greenwald, where the bank lost all of its $2.1 million in capital due to speculation in government securities, and at the Mayfield State Bank and the Murdock State Bank, both in Kansas, which lost a combined $4 million in capital. These losses occurred when interest rates soared in April, causing bond prices to fall. Regulators, in examining the losses, found a number of speculative and questionable activities. Some of these practices included:

- Investing the equivalent of 80 percent and more of deposits into securities;
- Buying interest-only or principal-only strip bonds (bonds with the coupons removed) without a specific investment strategy;
- Using borrowed funds ("margin") to buy securities;
- "Doubling down," a gamble in which a bank with bond losses doubles its portfolio so that a rebound of half the price decline will wipe out the loss;
- "Pair offs," in which a purchaser buys a security on the assurance it will not have to take delivery because the security is to be sold before the settlement date.[12]

The most infamous recent case of losses due to speculation in the bond market occurred this year when First Bank System of Minneapolis lost more than $700 million by guessing incorrectly on whether interest rates would rise. The loss represented about 60 percent of the holding company's net assets of $1.1 billion. The securities were transferred to the investment account, so the "loss" was not recognized. According to D.H.

Ankeny, Jr., the bank's chairman and chief executive, management thought that last April's interest rate surge was "just a blip -- that it would readjust itself. We weren't positioned properly for what happened."[15]

(ii) Discount Brokerage

Discount brokerage, which banks have been allowed to engage in since 1982, also poses risks, as the recent $22 million loss at Charles Schwab demonstrates. In short, Schwab lost the money because a large customer failed to meet a margin call during the stock market crash. According to American Banker, "much of the $22 million loss is due to the difference between the customer's unsecured obligations to Schwab of $84 million and the present value of a $67 million settlement of those claims. Also included in the reported loss are reserves for all other unsecured customer receivables of $13 million."[16] Mr. Schwab's explanation for the loss was simply that "traditional customer margin requirements on uncovered options did not anticipate such volatile markets."[17]

Schwab is now a free-standing securities firm; should such activities be carried on inside a bank? There is no third-party objectivity in making margin loans with federally-backed funds. Allowing banks to compete with local brokers for their banking customers' business is patently unfair.

(iii) Interest Rate Swaps

Unknown in commercial banking several years ago, interest rate swaps at domestic U.S. banks and the U.S. branches of foreign banks more than doubled in 1986 and stood at $479.3 billion at the end of that year. The Federal Reserve Bank of New York estimated the total credit exposure of the credit swaps carried on by U.S. banks to be $10 billion at the end of 1985. Yet, as the Federal Reserve Bank of New York said in a study published in April 1987, "The jury is still out on the effects of new instruments on market stability. . . . The question remains as to whether increased use of new instruments has created instability in traditional markets."

As these examples show, even the permissible securities activities of banks can lead to losses that may be unforeseen. SEC Chairman David Ruder recognizes this fact and publicly stated last week he would not support S. 1886 (the Proxmire-Garn bill) unless all such existing permissible activities were removed to a separate securities affiliate and were subject to regulation by the SEC.[18]

(f) Foreign Activities

Affiliates of U. S. banking organizations located outside the United States, usually Edge Act corporations and subsidiaries of bank holding companies, may engage in certain securities activities abroad that involve underwriting and dealing in debt and equity securities. However, they can only underwrite $2 million of equity securities without commitments by sub-underwriters or other purchasers, which greatly limits the risk of underwriting equities, the part of the securities business that is most subject to losses. Therefore, as stressed before, the limited experience of U.S. banking organizations in securities activities abroad does not support a loosening of restrictions on domestic securities activities of U.S. banking organizations.

8. Consumers And Citizen Groups Do Not Favor New Powers

Last week, the House Banking Committee invited four consumer and citizen groups to testify on the subject of Financial Services Restructuring. (The witnesses at the December 1, 1987 hearing on Financial Restructuring before the Committee on Banking, Housing and Urban Affairs in the United States House of Representatives were Alan Fox, Legislative Representative, Consumer Federation of America; Allen Fishbein, Director, Center for Community Change; Mildred Brown, President of ACORN, the Association of Community Organizations for Reform Now; and Jonathan Brown, Director BankWatch, part of Ralph Nader's Center for the Study of Responsive Law.) To provide the Senate Banking Committee with the benefit of their complete views, we have included the testimony of these groups before the House Banking Committee as Appendix III-B-8.] Consumer groups have not yet been very active on the Hill as this debate about bank roles has begun, but their concerns are nonetheless great. Their relative silence is a reflection of their limited resources rather than their lack of concern about the issues at stake. They can be expected to become more vocal as the debate continues.

Consumers have a tremendous stake in the outcome of this debate. Consumers have three fundamental concerns:

1. Will granting banks expanded securities powers result in banks' focusing on their upscale customers, thereby denying essential banking services to those who need them?

2. Will the economies of scale realized by banks that exercise new underwriting powers provide sufficient benefit to the economy to offset the negative effects of tremendous concentration, such as that which exists in West Germany,

along with the resulting lack of innovation in creating new products and lack of support for new start-up companies that comes with such concentration?

3. Will the federal insurance of deposits remain secure and will bank deposits be protected from being used to cover securities losses? Will banks be more susceptible to failure? Are the bank regulators, who currently are not enforcing the Community Reinvestment Act, capable of handling a new universe of bank activities and the accompanying increased risk to the banking system?

(a) Loss Of Essential Services

Mildred Brown, President of ACORN, the Association of Community Organizations for Reform Now, testified at the hearing. ACORN, the largest grassroots membership organization of low and moderate income people in the country, uses the Community Reinvestment Act (CRA) to compel banks to invest in low income communities. In her written testimony, Ms. Brown stated:

> "Banks want Congress' permission to sell and underwrite securities, insurance and real estate. But even if the bankers' most hopeful predictions come true -- even if these expanded powers promote competition and lower the costs of financial services to consumers -- this will provide no direct benefit to low income people. Unless Congress takes the necessary precautions, banks will use more and more of their resources and skills to serve the types of customers who can afford to buy stocks and real estate. The people that banks are already neglecting will receive even less attention."

Alan Fox, of the Consumer Federation of America, stated in his written testimony:

> Restructuring risks the establishment of a two-tiered financial system in which poor and working Americans are left with no or minimal services and exorbitant prices while large financial firms abandon basic services in favor of new powers. Large financial firms that take advantage of restructuring must have affirmative responsibilities to provide basic credit and deposit services to these customers.

Allen Fishbein, General Counsel of the Center for Community Change, a Washington, D.C.-based national non-profit organization that provides advice and technical assistance to community-based organizations representing the residents of low and moderate income and predominantly minority communities, also challenged the argument that expanded powers will bring about increased competition:

> At the same time, it is conceivable that financial services restructuring could lead banks to devote more and more of their resources to upscale customers who are expected to be primary users of expanded financial services products and thus, further intensifying the demarketing strategies to low income areas that has been associated with the earlier phases of banking deregulation. Moreover, we reject the notion, as some have argued, that expanded powers will increase bank profitability and automatically lead them to do a better job at serving the lower end of their traditional market.

In essence, these consumer concerns touch on what underlies the entire push for new powers; bankers do not want to be bankers. But banks are backed by the federal government to be bankers. Congress should not ignore this issue and should consider the real consequences of losing traditional banking services by allowing banks to be diverted into non-banking activities.

(b) Concentration Of Economic Power

Jonathan Brown, Director of BankWatch, part of Ralph Nader's Center for the Study of Responsive Law, while expressing a desire not to take sides with either the banking or the securities industry, makes many of the arguments made elsewhere in this testimony. Mr. Brown explains in his written testimony that the major consequence of granting banks new securities powers will be the concentration of financial power in the economy. He set forth this consequence as the primary negative factor in Congress' decision about whether to grant banks new powers and argues that such a balancing is one that Congress, not the bank regulators, should make. He says, in part:

> Giant financial conglomerates will have more leverage over industrial, commercial, and agricultural corporations than giant, but separate, banks, securities, and insurance firms. One of the real advantages of the growth of separate financial sectors in the United States over the last 70 years is that it inhibited the financial sector control over

> real sector corporations that was manifest in the heyday of the Money Trusts at the turn of the century. Today there is a broad consensus that financial firms should be the servants of corporations in the real sectors of the economy, not their masters.

Although the point is difficult to grasp, because generally the public thinks of both securities and banks as being very large, the relative size of securities firms as compared to the size of banks is quite small. In his written testimony, Mr. Brown acknowledges this fact and agrees that concentration of financial resources and power will result from giving banks new securities powers. Furthermore, Mr. Brown argues that the financial system in the United States has prospered under a decentralized system:

> Moreover, given banks' dominant position among financial institutions in terms of assets and capital, their access to the federal safety net, and their unique role in supplying liquidity, they are likely to emerge as the controlling powers in most major financial conglomerates. This would result in parallel rather than competing strategic interests among the larger financial conglomerates. Such a situation would most likely enable the larger financial conglomerates to follow a common strategy of promoting more expensive bank products, such as commercial loans, and de-emphasizing less expensive securities alternatives, such as commercial paper. This pattern is certainly in evidence in West Germany where banks control the securities industry and German industrial corporations are heavily dependent on bank credit, while the growth of corporate debt and equity securities has been stunted.

Mr. Brown likens the present financial system we have in the United States to our political system, in which there is a separation of powers. "For example," he writes, "a separate securities sector provides a better check on the quality of bank loans that are being securitized than a securities industry dominated by banks." He ends his written testimony stating:

> Unification of the financial service industry has contradictory implications. It may enhance efficiency and innovation in the delivery of financial services at the individual

> firm level, but the financial system as a whole may do a poorer job in servicing the real economy due to an augmentation of financial powers and greater instability. The Committee might well ponder an analogy between the separation of sectors within the financial industry and separation of powers under the United states constitution. Our constitution does not provide us with the most efficient decision making process, but what nation has designed a better structure for political stability?

SIA subscribes to this view.

(c) Regulators Have Not Proven Themselves Capable Of Handling The Regulatory Responsibility To Protect The Deposit Insurance System From A New Universe Of Risks Currently Not Protected By The Federal Safety Net

The four consumer and citizen groups that testified before the House last week were most unified on one point -- the bank regulators have not proven themselves capable of carrying out their current responsibilities and before their responsibilities are magnified and the federal deposit insurance system is subjected to a new universe of risk, the regulators must prove that they are capable of handling their current responsibilities.

The Consumer Federation of America's testimony stated:

> The most basic benefit provided to consumers and to the economy as a whole by the current structure of bank regulation is deposit insurance. Any change, structural or otherwise, that affects deposit insurance affects consumers' perceptions not just about the stability of individual institutions but of the banking and financial systems as a whole. Congress should exercise extreme care before making structural changes that could erode consumer confidence in deposit insurance.

Commenting on the current legislative proposals' ability to minimize problems, Alan Fox said:

> No such proposal quantifies the resources needed to ensure that the agencies can do the job. Nor does any proposal specifically

> provide the agencies with those resources. Of greater importance to consumers, none of these proposals recognize that the federal bank regulators are already overextended and that, as a consequence, they are not fulfilling all of their statutory mandates.

Mildred Brown of ACORN, from her experience of trying to enforce the Community Reinvestment Act, stated:

> And from where ACORN members sit, most regulators look and sound just like bankers. It is hard to believe that regulators are paid to protect our interests. With these experiences behind us, ACORN is worried about the grab by banks for expanded powers. Most banks have not come close to living up to their current legal responsibilities to serve low and moderate income people. (emphasis in original)

Because of their concerns that Congress has not fully addressed all of the potential dangers to individual consumers and to the economy as a whole associated with giving banks new securities powers, three of the witnesses requested Congress explicitly to extend the moratorium to enable Congress to fully investigate these concerns. Specifically, BankWatch suggested that Congress adopt legislation quickly that would set in motion a two year investigation of these issues under the direction of the House and Senate Banking Committees and that the legislation should identify the issues that Congress should investigate.

9. Banks Should Not Neglect Their Intermediary Role

Financial intermediation is an essential function in our economy. Only a very small percentage of American businesses can qualify for investment-grade ratings on their obligations. While a few of the rest may be able to issue so-called junk bonds, the vast majority need a bank with which they can develop an ongoing, reactive business relationship with sufficient mutual understanding to encourage the extension of credit and the proper handling of the credit relationship when things get rough. This vast majority is essentially a captive audience.

When Congress long ago instituted federal deposit insurance, it was clear that not only depositors but the banks themselves would benefit. The world now knows that the FDIC and the Federal Reserve discount window are firmly behind banking organizations and not just their $100,000 accounts. The aura of that government support makes money flow into bank certificates of deposits from all over the world on an unsecured basis at favorable rates. When Congress conferred this benefit on the banking industry, however, it did not intend for banks to take the money and run in all directions with it. It was banking, the critical job of the financial intermediary that provides credit to companies and citizens that cannot access the capital markets, that was to be backed by federal insurance funds and the federal treasury.

Expansion of banking organizations into additional non-banking activities would not only jeopardize the federal safety net surrounding the insured deposits, but would encourage neglect of the functions that are the raison-d'etre of banks and create a void in our economic structure. If banking organizations, as they claim, can make bigger profits elsewhere, will traditional lending become a poor cousin when banks are given carte blanche to engage in other activities? If Salomon Brothers is driven by balance sheet concerns to eliminate its municipal bond operations, will bank holding companies cut back on their banking operations if their performance is mediocre relative to their non-banking subsidiaries? Bank holding companies are supposed to tend to their banks; bank holding companies that hold banks and an assortment of other subsidiaries may not, if the drive to maximize the bottom-line leads them to neglect their banking role. If this phenomenon is encouraged, financing for essential sectors of the economy such as the farm and energy areas and small business may become scarce, to the detriment of the nation's financial health.

10. Securities Industry Is Highly Competitive

The American securities industry has served American business very well over the past fifty years and has been an important source of equity capital for new businesses and for growth and liquidity for existing businesses. The innovation in securities instruments and in financing transactions has been remarkable, particularly in the past ten years.

Statistics on the volume of underwriting tend to indicate that five or six firms account for the majority of underwriting of certain types of debt and equity securities. This data has been cited as evidence of concentration in the securities industry, but concentration should not be confused with lack of price competition. Indeed, in his testimony last month before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs, Alan Greenspan, Chairman of the Federal Reserve Board, while discussing competition in the securities industry, stated, "I would emphasize that concentration per se need not lead to higher consumer costs, because the possibility that new firms will enter a market may be sufficient to achieve competitive prices."

The securities industry is highly competitive and margins on underwriting and brokerage services have tended to decline in recent years. While profit levels have been good over the past few years, the health of the industry has been cyclical, and the present period is one in which there have been a large number of layoffs and mergers. The 1970s witnessed a severe shakeout as hundreds of firms failed or merged and thousands lost their jobs under the competitive strains.

Developments in the securities business in the last six to eight years have shown the need for increased capital for securities firms because of the size and risks of transactions. The industry is wide-open to entrants; anyone except banks can become involved in any and all aspects of the securities business and many try. Capital and expertise are essential ingredients. There have been a dozen major acquisitions of securities firms by financial and non-financial companies and mergers among securities firms. Some commercial firms have been a strong source of capital for the securities industry.

The lead underwriters in major transactions recently have had capital of over $500 million and often over $1 billion. Because of the special nature of the securities business, particularly the large size of many transactions and related large capital requirements, new entrants into the business tend to specialize in niches rather than compete for a lead position in the larger transactions. The potential for mergers or entry into the business by non-financial companies, nevertheless, exercises a moderating influence on pricing in the industry. As Chairman Greenspan indicated, this is the effect of potential future competition, which regulatory agencies and courts take into account in deciding whether a sector is unduly concentrated. Appendix III-B-10 shows that the top five U.S. securities firms ranked by capital over the past eight years has changed and has been shared by nine different firms, evidence of the competitiveness of the industry. The appendix also shows the marked increase in growth in capital of these firms that has been required to compete in their segment of the market. For example, the top ranked firm in 1980 had just under $1 billion in capital and the top ranked firm in 1986, which was the fourth ranked in 1980, had over $3 billion in capital.

It is also important to realize that the securities industry is not composed of only large companies. There are many companies, indeed hundreds, that have only a small number of employees and a handful of offices and they constitute an important segment of the business. Altogether, there are over 5,000 firms in the securities business.

Independent of the question of whether from an abstract competition viewpoint banking organizations, as additional suppliers of services, should be encouraged to enter the securities business to a greater extent, is the issue of whether this is appropriate policy. Large banks, in particular those who have severe exposure from loan positions with developing nations, do not seem to have much, if any, excess capital right now for their banking activities. Also, because the risk-reward ratio of handling large transactions is high, it is questionable whether banking organizations should be encouraged, on public policy grounds, to enter the securities business to provide an additional source of competition because organizations affiliated with government-backed deposit insurance funds should not, on policy grounds, be allowed to become vulnerable.to the shocks to which the securities business is prone.

A recent study on rapid financial market change and systemic risk, by the Bank for International Settlements in Basel, Switzerland, emphasizes two factors that contribute to risk in the securities business -- the innovation in financial instruments and their pricing and the speed and force with which market strains may be transmitted around the globe with the international integration of financial markets. The study emphasizes that the pricing of new instruments is difficult and there has been considerable mispricing of such securities and transactions in large part because of competition that increases systemic risk:

> Financial markets are highly competitive . . . and there is continuous pressure to narrow profit margins. If in this environment, markets seriously underprice assets, then losses will appear, which, if widespread, could dilute the capital base of financial institutions and expose the financial system as a whole to risk.

SIA believes that the securities industry is highly competitive and that special risk factors of the securities business mitigate against placing the federal safety net at risk in the false name of increased competition.

IV. BANK PARTICIPATION IN SECURITIES AND OTHER NON-BANKING ACTIVITIES WILL RESULT IN UNFAIR COMPETITION AND CONFLICTS OF INTEREST

Bankers are fond of calling for repeal of the Glass-Steagall Act to create a "level playing field" permitting head to head competition between banks and securities firms. However, banks enjoy a variety of government-conferred special benefits that enable them to transact business at a significantly lower cost than non-banking competitors. In addition, their role as lenders enables banks to use their credit facilities to tie-in unrelated services. The entry of banks into non-banking activities is therefore likely to create not a level playing field, but a field sharply tilted in the direction of banks. It is not only the integrity of competition that is called into question by the participation of banks in non-banking activities, however, but the integrity of banks themselves, which may lose their objective role as lenders if they simultaneously participate in other transactions with, or in competition with, their credit customers.

A. Banks Have Substantial Government-Conferred Advantages

Any business opportunities the banking industry may have lost in 1933 with respect to securities activities that were placed off limits to banks by the Glass-Steagall Act were more than compensated for by new federal support for basic banking activities. This support includes the following special advantages:

- Ability to take deposits for use in their business
- Federal insurance of deposits which inspires U.S. government-created confidence in the banking system: it is assumed that the government will protect and save the bank; therefore, a company or individual would rather deal with a bank than with an institution which is not a bank, all other things being equal
- Because banks have their federal safety net, they have accumulated vast pools of deposits and other funds with which to extend credit and can use that power to support their securities activities
- Exclusive direct access to the payments system for making payments for U.S. government securities and dollar-denominated international transactions and foreign exchange (particularly Fedwire and CHIPS)
- Continuing tax advantages
- Federal funds market availability for low-cost funds

- Regular access to the Federal Reserve discount window
- Special accounting rules, especially those which do not require them to mark to market.

Backed by federal deposit insurance, the banking industry has grown immensely since 1983. Because the biggest banks are now "too big to fail," federal backing, and the confidence it inspires in banking, often extends to the bank itself, not just to the insured accounts (now $100,000). Indeed, in recent years bank regulators have saved not only banks but entire bank holding companies. Consequently, even the supposedly uninsured creditors of the banks and the holding companies (through certificates of deposits and otherwise) derive tremendous comfort from knowing that they are dealing with federally-protected institutions. That confidence is reflected directly in a lower cost of money raised by banks compared to financial institutions that do not have federal backing. The cost advantage conferred upon banks by deposit insurance is enormous, particularly assuming that the FDIC is in fact insuring the bank and not just deposits up to $100,000:

> [A]ssume a gap of 25 basis points between what the money center banks now pay for money and what they would have to pay if the big borrowings were regarded as uninsured, assume that two-thirds of the footings at such banks are supported by such borrowings -- all reasonable assumptions -- and the value of the "deposit" insurance protection the FDIC gives away to the big banks provides roughly one-third of their profits.[11]

Although interest rate ceilings on bank deposits have been removed, the attraction of federal insurance still enables banks to borrow from depositors at favorable rates. In fact, some legal preclusions on payment of interest to corporate customers on bank demand deposits still survive, yet the federal safety net provides an incentive for such customers to provide banks with no cost funds.

This assortment of benefits was conferred on the banking industry by Congress on the assumption that they would not be major players in non-banking industries, and that the subsidies provided thereby would inure to the health and stability of the traditional intermediation function of banks. Congress did not intend these advantages to carry over into bank participation in financial or commercial enterprises that could stand alone without government support. Yet the bills being considered by the Committee do little to isolate those advantages to the banks' intermediary functions, and certainly the banks that demand a repeal of Glass-Steagall are not volunteering to surrender those advantages.

The list of bank advantages does not stop, however, with those conferred intentionally by legislation or regulation. Banks as sources of credit in time can dominate any market. The availability of credit can be tied explicitly or implicitly to use of a bank's securities or other non-banking services. It happens all the time. And it is virtually impossible to police.

B. Banks Tie-In Credit With Other Services

One example of how banks routinely leverage their credit enhancement facilities to obtain entry into other financial services is that of municipal bond underwriting. Two studies of bank tie-ins in this area are attached in Appendix IV-B-1 and IV-B-2 to this statement. The results could not be more emphatic or more instructive. One of the studies involves long-term municipal housing revenue bonds with "put" features that allow the holders to tender the bonds back to the issuer at periodic intervals prior to maturity. As indicated in the study, only large commercial banks have the liquidity to back up such a repurchase obligation. Before the advent of housing bonds with "put" features requiring such liquidity facilities, banks had minimal participation in the underwriting of housing bonds. Bank participation in managing underwriting groups increased dramatically as soon as they became involved in such transactions on the credit side. In fact, according to the study, in 24 of 24 negotiated housing bond offerings involving a letter of credit by three major banks, the banks also participated in the managing underwriting group. Conversely, none of the banks was involved in underwriting such bonds if they did not supply the credit facility. According to the second study, 125 out of 146 banks that participated as lead managers of housing financings during the period 1980-1987 also supplied the letter of credit.

The potential for tie-ins exists as well in the underwriting of mortgage-backed securities, insurance and other financial instruments or services. Such tie-ins are impossible to eliminate because they are frequently "voluntary," occurring without any prompting by the bank. For example, when short-term credit becomes a relatively scarce and valuable commodity, customers may feel obliged to be "good customers" of their banks in all respects. A federally-backed organization should not be able to apply such subtle coercion, at least as it affects consumers and other peoples' businesses.

The possibility of tie-ins occurring seems all the more likely when one considers the active "cross marketing" of products in which banks engage. Yet none of the bills before the Committee put any restraints on cross-marketing; to the contrary, it is explicitly encouraged. What is "synergy" for a banking organization is unfair competition for a company that does not have such government-conferred benefits.

In sum, banks are inherently unfair competitors outside of banking if, as is now the case, they can use their banking relationships, credit sources, credit support and captive markets in their other businesses. The situation will be made dramatically worse if bank non-banking activities are allowed to grow.

C. Bank Participation In Non-Banking Activities Will Create Conflicts Of Interest

Common ownership of banking and non-banking facilities leads inevitably to conflict of interest situations in which the bank's status as an objective, dispassionate lender is subverted to the detriment of the bank or the bank affiliates' competitors. Neither existing legislation nor any of the bills before the Committee are adequate to prevent improper use of credit facilities by banks in transactions relating to their non-banking affiliates. The only way to avoid such conflicts is to minimize the non-banking activities being conducted within a banking organization.

The most clearcut conflict situation is where a bank's resources, supported by the federal safety net, are diverted to a non-banking affiliate on terms less favorable to the bank than would be obtained from a third party or in situations where such resources would not be made available to a third party at all. Although Sections 23A and 23B of the Federal Reserve Act attempt to legislate away such conflict of interest opportunities, they are at best mild restraints. As Robert Litan of the Brookings Institution has noted:

> As controlled as inter-affiliate transactions may be, however, insured depositories belonging to diversified financial organizations can still exploit conflicts of interest by favoring nonbank affiliates. At a minimum, bank holding companies may use various sub rosa mechanisms to channel resources from their banks to their nonbank corporations: by imposing higher service or management fees on their banks, by increasing their depositories' tax reimbursements to parent companies, or by making subtle adjustments in inter-affiliate pricing. Each of these techniques may be difficult to detect and can be used as a device

> for systematically bolstering the nonbank activities at the expense of bank loan customers.
>
> Why would a profit-maximizing banking organization use its bank subsidiary to support nonbanking operations that may offer lower returns on invested capital at the margin than banking activities? The answer lies in the interest of any financial organization in preserving its reputation for soundness in all activities, specifically in preventing a run on the bank by depositors who may erroneously believe their funds would be threatened if nonbank affiliates were to become insolvent.
>
> . . .
>
> In short, despite all the restrictions on transactions between banks and their affiliates, banks are likely to be sorely tempted or forced by their holding companies to assist troubled affiliates. Such action poses a potential conflict of interest because the rescues divert resources that could otherwise be loaned to bank customers; in the extreme case, the drain on the bank could pose serious risks to the continued soundness of the bank itself.[11]

An equally disturbing conflict of interest arises with respect to the willingness of banks to extend credit to competitors of their affiliates. Securities firms with their overnight loan requirements are among the bank's biggest customers. If banks or their affiliates are granted full securities powers, will banks continue to make credit available to their main competitors? The problem will also be acute in less populated areas, where the banking markets are quite concentrated. As Litan points out, independent insurance agencies or real estate brokers may have trouble obtaining bank financing if all area banks, or their affiliates, are engaged in insurance and real estate activities.

A third type of conflict of interest is a corollary to the unfair competition problems created by bank tie-ins. Banks may attempt to bolster or expand the customer base of their non-banking affiliates by making credit more readily available to potential or existing customers. Such looser credit standards, or lack of credit standards, would run directly counter to the quintessential function of banks, which, as the Supreme Court noted in ICI v. Camp., was intended to be the sober, objective central supplier of credit to the economy, free and independent of the entrepreneurial and heavily profit-motivated urges of the rest of the financial world.

A more detailed discussion by the OECD of the conflict of interest problems associated with bank participation in non-banking activities is contained in Appendix IV-C to this written statement.

D. An Internal Firewall Is Weak And Unproven

Advocates of bank entry into securities or other non-banking activities concede that the breaking down of Glass-Steagall barriers and Bank Holding Company Act barriers could potentially raise the level of risk to the federal safety net and the prospects for unfair competition and conflicts of interest. They assert, however, that something less than a flat separation of banks from non-banking organizations will suffice to contain these adverse aspects of bank integration with other financial or commercial entities.

In particular, the concept of separate non-banking subsidiaries of a bank holding company accompanied by legal restrictions on transactions between banks and such non-banking affiliates, has been touted as an insulation mechanism that will keep banks isolated while permitting their holding companies to reap profits in other sectors of the economy. This separate subsidiary with a "firewall" concept is the cornerstone of S.1886, the Proxmire-Garn Financial Modernization Act of 1987. However, the firewall there will not keep out many fires.

Chairman Proxmire has said that he could not support a repeal of the Glass-Steagall Act if banks were permitted to engage in securities or other non-banking activities in their own subsidiaries, because the temptation to rescue an ailing subsidiary would be too great. Paradoxically, the Chairman's bill, as discussed in Section V-B of this statement, permits many securities activities to be conducted directly within a bank. But that aside, there is little evidence that the temptation of a banking unit of a bank holding company to rescue another unit or to otherwise benefit another unit is significantly affected by the location of that other unit within the bank holding company structure.

Testifying about his experience in regulating bank holding companies, former Federal Reserve Chairman Paul Volcker has noted:

> We have found that the practical realities of the marketplace and the internal dynamics of a business organization under central direction drives bank holding companies to act in greater or lesser degree as one business entity, with

> the component parts drawing on each other for marketing and financial strength. Certainly the market conceives of a bank holding company and its components in that way. And if market participants tend to consider the bank holding company as an integrated entity, problems in one part of the system will inevitably be transmitted to other parts.[11]

Legal barriers to transactions within a bank holding company are at best unreliable. Paul Volcker has made this point forcefully:

> The idea that you can have a corporation with a banking arm and commercial businesses of various sorts and other affiliates and hope they're going to be operated independently, and the bank is going to be a bank out there operating more or less as the traditional bank, subject to all emoluments, privileges, and disabilities that that implies, and it's not going to be integrated as a management matter with the rest of the organization, just flies in the face of experience, law, logic, and economics.
>
> We see that constantly within bank holding companies today when they are not in the commercial business. When you have a troubled bank holding company, you will almost invariably find that the management will have, by one device or another, tended to, if it's got a strong bank, use the strength of that bank to support the rest of the holding company or vice versa.
>
> Now there are restrictions on that in law in terms of direct lending between the bank and the rest of the holding company, but those restrictions aren't fully effective in getting at all the ways that one part of a business organization can support another. You can do something so simple as declaring a larger dividend from the bank than you otherwise would declare simply because you've got to get some more capital into the rest of the holding company, and the bank is left in a less strong position than it otherwise would be if that possibility didn't exist.

> Now we can run around as supervisors and try to catch up to that kind of thing usually after the fact, but it's very difficult when basic incentives exist.[11]

Recent experience confirms the weakness of legal barriers within an organization. The rescue of First Options of Chicago by its parent bank and bank holding company is a case in point. Continental Illinois violated the limits on lending to its subsidiary to prevent it from failing. The Comptroller was only able to correct the situation with an after the fact consent decree. Moreover, the largest shareholder in the bank holding company is the FDIC. Thus, not only the Comptroller and the Federal Reserve Board but also the FDIC were overseeing the activities of the bank holding company and the bank, yet legal limitations were breached.

In this most recent episode involving Continental Illinois, it appears that the bank regulators were left somewhat in the dark. But one cannot assume that the result would have been different if the regulators had full knowledge of the pertinent facts. After all, only a few years ago, the regulatory authorities bailed out not only Continental's failing subsidiary but the holding company itself, at a cost of billions of dollars, because they feared that if the holding company or its nonbank subsidiaries were permitted to fail, additional runs on the bank would be triggered.

The REIT situation is another case in point. In the mid-1970's, the financial condition of many bank and bank holding company-sponsored real estate investment trusts became precarious. Although the banks and bank holding companies were not legally responsible for the REITs, they funneled support to them to avoid the adverse effects of the public's perception that their organization's financial fortunes were linked to those of the REIT's.

According to the FDIC's recently released report entitled "Mandate for Change," this perception of the interdependence of the bank holding company's units was shared by bank regulators. The report states:

> While it is clear that banking organizations had an incentive to aid the REIT's they sponsored, it should be pointed out that regulators could have tried to discourage such aid but they did not. In fact, the Federal Reserve supported efforts by banks to save their REIT's. If the Federal Reserve had taken a strong stand against the practice of

> diverting bank resources to troubled REIT's, the diversions may not have occurred. (emphasis added).[11]

As the FDIC's own conclusion suggests, one cannot be certain that, even if bank regulators are aware of problems of the non-banking affiliates of banks and attempt to dissuade banks from using their federally insured deposits in a rescue operation, such attempts will be successful. But experience suggests that regulators cannot be aware of all internal difficulties of a bank holding company in time to stop interaffiliate transactions, and that, even when regulators are aware of the difficulties being experienced by such affiliates, they may share the organization's perception that the organization must stand or fall as a whole.

It may be that a better mousetrap can be built, that a stronger firewall can be put in place, that more regulators can be hired. But it isn't certain, and it isn't even probable. Certainly, until the effectiveness of such a firewall is proved, it should not be the premise on which additional non-banking powers are granted to banking organizations.

V. WHAT IS WRONG WITH THE PRESENT PROPOSALS?

The Financial Modernization Act of 1987 (S. 1886), the Financial Services Oversight Act (S. 1891) and the Depository Institution Affiliation Act (S. 1905) all assume the elimination of the Glass-Steagall Act and some or all of the Bank Holding Company Act. SIA remains unconvinced that moving in this direction is in the best interests of banking, commerce or the country. SIA believes the Glass-Steagall Act and the Bank Holding Company Act, if administered as they were intended, can continue to be powerful forces for sound banking, diverse, competitive, dynamic and effective capital markets and wide-ranging financial choices for American businesses and consumers. Because both these acts have been weakened by bank regulator interpretations is no reason to hasten their demise. They have worked well and can continue to do so. We believe they should be strengthened as outlined in this testimony.

If Congress nonetheless desires to consider allowing banks to do more in non-banking areas, then the only fair approach is to dismantle both the Glass-Steagall Act and the Bank Holding Company Act in their entirety, thus permitting all companies to affiliate with banking organizations. Because of the continuing restrictions of the Bank Holding Company Act, there is no practical reciprocity for securities firms under either the Financial Modernization Act or the Financial Services Oversight Act. See Appendix V-A for a listing of some of the publicly-known affiliations of securities firms which do not qualify under the Bank Holding Company Act. (Of course banks already comply with the Bank Holding Company Act; securities firms, being of commerce, not banking, have many affiliations which do not fit under the Bank Holding Company Act.)

Therefore, while the Depository Institution Affiliation Act may not represent the wisest approach, it clearly is the fairest; only a thorough evaluation will tell us if in fact it also represents the best course to follow. If the Glass-Steagall Act is outmoded, perhaps the Bank Holding Company Act is also. Consequently, the Depository Institution Affiliation Act should be the principal focus of any consideration of change that would weaken the existing system.

The Financial Modernization Act and the Financial Services Oversight Act each are one-way streets for bank takeovers of particular industries: in the first, the securities industry is separately targeted, in the second, securities, insurance and real estate all appear in the sights.

Both bills bestow enormous power on bank regulators to decide what further powers banks should acquire outside of banking. SIA disagrees with this approach as a philosophical matter. Congress should keep control of these decisions, since it is the policy-making body that stands behind the insured deposit funds. Neither bill effectively isolates unfair bank advantages from these non-banking activities, thus virtually assuring the eventual domination of these non-banking areas by banking organizations.

SIA does not believe that the total elimination of the Glass-Steagall and the Bank Holding Company Acts is the right answer for America, but it far prefers that to what is proposed by the other two bills. SIA prefers its own plan, which is discussed later in this testimony. SIA's plan has the advantage of reducing present risk to the federal safety net, reducing unfair competition in present bank non-banking activities and opening the way for Congressional consideration of doing away with the division between banking and commerce in a way that should not increase risk for the nation.

There is too much at stake in the radical restructuring proposed by these three bills for Congress to go forward blindly. It can test out its theses in complete safety. Our approach spells out in detail what Congress should do. It is a comprehensive plan that can be implemented safely. The key is its orderly approach to dealing with these very important, very complex matters. It eliminates the need for Congress to gamble, to cross its fingers and hope that what it is doing will work. Just 60 years ago, in 1927, Congress passed the McFadden Act, which, among other things, legalized securities affiliates for banks. Disaster soon followed and Congress corrected its mistake in the Glass-Steagall Act in 1933. We do not need a repeat of that experience.

A. The Financial Modernization Act Of 1987 (S. 1886)

The Financial Modernization Act of 1987, introduced by Senators Proxmire (D.Wisc.) and Garn (R.Utah), focuses primarily on allowing banks to engage in securities activities within a holding company structure. The bill allows bank holding companies to own, and insured banks to be affiliated with, firms that underwrite all manner of securities, including corporate debt and equity.

For all the good intentions of its draftsmen, S. 1886 must be substantially modified before it can provide a safe framework of regulation for the American financial system. We suggest it be modified as proposed in SIA's plan outlined later in this testimony.

Initially, it should be noted that the Proxmire/Garn bill repeals the Glass-Steagall Act, thus allowing banks to affiliate with securities firms. However, the bill leaves intact the provisions of the Bank Holding Company Act which will keep securities firms that are owned by commercial firms from affiliating with banks. As mentioned above, a list of some of the publicly-known affiliations of securities firms is attached to this testimony as Appendix V. Therefore, the bill is a one-way street for banks to enter the securities industry; most securities firms would be disadvantaged by this bill.

Can the bill be reshaped? Basic modifications that are necessary include the following:

1. Securities Activities Should Not Be Conducted Directly By Banks Within The Banking Organization

All of the present securities and "securities-like" activities, such as options and futures, of a bank, thrift or bank holding company and all of its affiliates should be isolated from the rest of the banking organization, both at home and abroad, to prevent risk from securities operations jeopardizing the safety of the rest of the banking organization, the federal deposit insurance funds and the U.S. Treasury, and the unfair use of banking powers to enhance the banking organization's securities business.

Rather than transferring existing securities activities to the securities affiliate, S. 1886 not only allows banks to continue their current securities activities, it actually allows banks to expand their securities activities, thereby expanding risk to the system and bank unfair advantage:

(a) Banks may underwrite directly any securities expressly permitted by statute (such as the laundry list of securities in 12 U.S.C. §24) or by a regulation of the Comptroller promulgated with respect to that statute before November 18, 1987. This latter provision is a blatant ratification of questionable interpretations of the Comptroller that do not reflect the intentions of the framers of the Glass-Steagall Act. The speculation by banks in government bonds of all kinds can continue.

(b) Banks may underwrite and deal in municipal revenue bonds, thus expanding bank participation in municipal bonds by more than 100 percent.

(c) If the bank holding company does not have or form a securities affiliate, the bank may deal in and underwrite certain unit investment trusts and distribute mutual funds that are not organized, sponsored, managed or controlled by the bank or any affiliate of the bank.

(d) Banks are allowed to continue to engage in securities brokerage, investment advisory services, private placement and other securities activities permitted for broker-dealers or investment advisers. Brokers all over

America will continue to suffer from the unfair competition of their local bank, which clears customer checks and scans the customer lists.

These are important activities and not requiring their transfer to a securities affiliate belies any assertion that fairness is being attempted by the bill or that risk is being materially reduced. Many of these activities pose serious risk to the federally-backed banking system; leaving such activities in the bank invites conflicts of interest, the warping of allocation of credit and anticompetitive effects, such as tying. All of such activities should be transferred to a securities affiliate. SEC Chairman Ruder supports the transfer of all such activities to a separate affiliate regulated by the SEC.

In addition, if banks are allowed to continue present securities activities, they will continue to do so at an inherent advantage because the differing tax and accounting treatment accorded to banks will give them unfair advantages over their non-banking competitors. That assets of a bank are ordinarily carried at cost rather than constantly marked to market as required of a broker dealer is well-known. The only way to begin to consider equalizing treatment of all parties in performing similar functions is to move all securities and securities-like activities to a walled-off securities affiliate complex.

2. No New Non-Banking Powers Should Be Given To Banking Organizations At This Time

Whatever concerns one might have about allowing banks to be affiliated with securities operations are only heightened by the fact that the bill proposes to allow bank to be affiliated with a securities firm that can underwrite all corporate securities, including junk bonds and equities. Unlike U.S. government bonds, junk bonds and equities cannot be put into a portfolio to mature; if a loss is realized, there may never be a payback. This proposal thus represents a staggering leap beyond prior proposals, including proposals submitted previously by the sponsors of this bill that took the cautious approach of allowing banks four additional powers that one could argue involve less risk and bear some relation to what bank holding companies and banks have been engaged in: revenue bonds (compared to general obligation bonds, but no taxing power behind them); private mortgage-backed securities (compared to government mortgage-backed securities, but without the government connection); mutual funds (compared to trust and pension accounts); and commercial paper (compared to short-term credit, a specialty of a commercial bank).

SIA suggests that the business of underwriting and distributing securities should not be included in a banking organization at all. While it may be unrealistic to suggest that existing securities activities should be discontinued, as discussed elsewhere in this testimony, such activities do place risk unnecessarily on the federal safety net, do divert banks from their essential roles as bankers and too often involve unfair competition on the part of banks, from tying to conflicts of interest and abuse of confidential information. The dangers of increased risk and unfair competition can be defused by requiring such activities to be isolated in a securities affiliate removed from the rest of the banking organization. However, the isolating structure may not completely work. Therefore, no new securities powers should be given to a banking organization until Congress determines whether the new structure will work.

Whenever a line is drawn there is always some quibbling about whether something should be on one side or the other. The Supreme Court said that commercial paper was a security and belonged to the securities side if it involved underwriting, or taking risks such as are run in the capital markets. While short-term debt may be the least risky instrument for banks to acquire if they were to acquire new securities powers, there is no particular reason to grant such powers to banks at this time. Their profitability will not be enhanced. New powers should await the completion of the comprehensive review which Congress has now started; it may be that the one-way invasion of the securities, real estate and insurance industries may not take place, if Congress decides to enact something akin to the Depository Institution Affiliation Act.

SIA has said it before: revenue bonds are riskier than general obligation bonds; the WPPSS bonds are testimony to that. Private mortgage-backed securities are riskier than government-sponsored securities. Mutual funds have their own sets of risk. Since the case has not been made for the grant of such powers to banks, the Glass-Steagall line should not be further bent.

And to grant banking organizations the power to underwrite corporate securities opens up the specter of bank control of American business. Will we gradually become like Germany, where bank ownership and domination of businesses is common? Why should commercial companies then have the power to acquire banks? What are the risks? Junk bonds, convertible debt, warrants, stocks of all kinds; what does this have to do with banking? Why should these risks be associated with a federally-backed banking organization? Congress has not considered such questions since 1933 and it should not even contemplate such an extension of power to banking organizations without first conducting a very detailed and careful study of all of the implications.

3. A Truly Effective Firewall Should Be Erected Between The Other Members Of The Banking Organization And The Securities Affiliate

Before considering any new securities powers for banks, Congress should put in place, to reduce existing anticompetitive effects and risks presently borne by the federal safety net, a solid firewall between the securities affiliate, with all present securities activities transferred to it, and the rest of the banking organization. The Proxmire/Garn bill does attempt to wall off the securities affiliate from the rest of the banking organization but does not go far enough:

(a) Infusions Of Equity Capital

The bill allows the banking organization to make an initial infusion of equity capital to the securities affiliate if such infusion does not reduce the equity capital of the bank holding company below regulatory requirements. However, subsequent infusions of equity capital, as the bill permits, should be prohibited. Subsequent equity should be obtained outside the banking organization so that the securities affiliate will not be dependent upon financing from its banking affiliate and so banking capital is not diverted from government-backed depository institutions. The recent Continental/First Options situation illustrates the need for this requirement.

In addition, the bill refers merely to the capital requirements established by regulators. The present six percent requirement should be codified into law. Also, until the firewall has been proven effective, the bill should provide for higher capital requirements for a banking organization affiliated with a securities firm. The level of capital for the securities affiliate should be established by the SEC.

(b) Extensions Of Credit To The Securities Affiliate

There should be an absolute prohibition on extensions of credit from all units of the bank holding company complex to the securities affiliate. The provisions on capital adequacy contained in the bill make infusions of credit into the securities affiliate a wash for the bank holding company. The holding company does not have to count extensions of credit to the securities affiliate in calculating its capital adequacy. By excluding loans to the affiliate from assets of the holding company, one is in effect assuming that there is no risk that the loan will not be paid. But of course there is a risk and without an adequate capital cushion the holding company will be more likely to need the protection of the federal safety net. Finally it is too easy to move money around inside of a holding company family, so the prohibition of credit extension must apply to all units. The securities affiliate should obtain its credit elsewhere.

(c) Participating Jointly In Financings

A significant unfair advantage for a bank is the ability to tie its credit facilities to its underwriting or other securities activities such as investment advisory services or private placement. Such tie-ins have been used effectively by banks to enter management groups in housing bond underwritings, as illustrated in Appendix IV-A. The bill should address the myriad ways in which both the bank and the securities affiliate can participate in a transaction and thus trade on the federally-backed status of the bank to tie such services. For example, the following situations should be prohibited expressly:

> (i) No member of the banking organization should be allowed to participate in transactions where its securities affiliate is serving as underwriter, financial advisor or placement agent. This is particularly important where bank credit facilities are being used.
>
> (ii) A bank should not be allowed to spin loans off its balance sheet and repackage them as securities underwritten by its affiliate, even if such securities are rated by a rating agency.

(d) Separate Personnel

In order to ensure that the securities affiliate does not make use of an affiliated bank's advantages, units of the banking organization and the securities affiliate should have no common personnel. There should be no exception for holding companies of any size or for regulator-approved situations, as provided in the bill, except for directors in common between the securities affiliate and the parent itself, with appropriate safeguards. Further, the prohibition should extend beyond officers and directors to cover all employees.

(e) Customer Information

Information is the essential link in the provision of financial services. The securities affiliate should be prohibited from sharing confidential customer information with any other unit of the holding company, including any bank. It is not enough to allow the exchange of information only with customer consent. The customer usually has neither the incentive nor the perspective nor often the courage to prevent such exchange of information.

(f) Separate Identities Must Be Ensured

The bill, paradoxically, tries to ensure that customers of the securities affiliate do not assume mistakenly that they are dealing with the bank by having the securities affiliate make clear disclosure that there is no connection, but this information merely serves to *reaffirm* that connection and guarantees that the federally-protected aura of the bank will extend to the securities affiliate as well. It is clear from past experiences (for example, with real estate investment trusts (REITs) during the 1970s) that the public can easily be confused or misled into believing that bank credit is behind the operations of an affiliate. The securities affiliate should have a separate and distinguishable name and not be advertised as associated with the bank affiliate, directly or indirectly. The GAO report on risk to the federal deposit insurance fund posed by the expansion of bank powers acknowledged clearly the possibility that identification of the securities affiliate with the bank, however mistaken, was something to be guarded against lest problems with the securities affiliate lead to a run on the bank. The securities affiliate should similarly be located on premises separate from any member of the holding company complex.

(g) No Common Dealings With Customers

Dangers are posed not only where the bank and the securities affiliate participate in the same transaction; related transactions can pose similar problems and should be prohibited. An example is the provision of credit by the bank in order to pay debt service on securities issued by the securities affiliate. The bill allows such arrangements if the extension of credit is for a documented purpose and if the timing and terms of such credit are substantially different. This is probably an enforceable requirement and, even if enforceable, still allows the bank and the securities affiliate to benefit from anti-competitive synergies.

(h) Extend Firewall To The Holding Company

As a general principle, it is necessary to extend the restrictions between the activities of the affiliated bank and securities firm to all members of the holding company structure. Otherwise, the holding company can arrange easily to circumvent the restrictions placed upon the bank by alternative means. For example, the bill contains looser restrictions on extensions of credit by the bank holding company than by the bank. The restrictions should be equally stringent.

3. Securities Affiliates Should Not Be Allowed To Clear Through The Facilites Of An Affiliated Bank

The bill provides that the bank may extend credit to its securities affiliate on a fully-secured, same-day basis in order to acquire government and agency securities. This provides a source of cost and profit advantage to the securities operations of a bank. Such arrangements should be prohibited.

4. Treatment Of Foreign Activities

Since the activities conducted outside the U.S. by affiliates of bank holding companies can adversely affect the federally-insured American banks and since foreign-based securities affiliates also enjoy the benefits of insured deposits and the federal safety net, the framework suggested here should apply internationally as well. Bringing operations abroad into line with domestic authorizations should be considered as well.

5. Congress Should Ensure That It Maintains Control Over National Financial Policy

In order to ensure that national financial policy is applied consistently, the overall statutory structure, its conditions and restrictions, should apply to a bank or thrift holding company and all of its affiliates, whether or not federally-chartered, as long as one or more of the banks or thrifts in the banking or thrift organization is federally-insured.

The statutory framework that had worked for years has gradually been destabilized, in part by the actions of banking regulators who have expanded banking powers through loopholes. The new legislation should be structured to ensure that Congress controls the policy decisions in this area. Loopholes which regulators assert exist in present laws, such as the "engaged principally" loophole, should be closed. The Comptroller's interpretations involving "bank assets" being securitized and the sale of "bank securities" should be ruled out of line.

Rather than closing up these loopholes, however, the bill actually creates some new ones, which should not be allowed. For example:

(a) The bill allows a bank holding company to engage, through the securities affiliate, in such activities as the Federal Reserve Board will permit and expands the "closely related to banking" standard that the Board will use in making these determinations. Congress should keep control over such decisions, particularly until the revised structure here proposed is tested out.

Furthermore, to permit a securities affiliate to engage in such activities that involve extensions of credit, as those conducted by commercial credit, leasing, and mortgage banking companies, is to invite abuses and conflicts of interest between the securities affiliate and such companies' customers that proposed legislation should seek to avoid rather than encourage.

(b) The bill allows the Federal Reserve Board to grant exceptions to the prohibitions on employee interlocks. By limiting the opportunities for regulators to step in again and destabilize the situation, Congress in effect would only be holding onto the authority over national financial policy that it reacquired through the Competitive Equality Banking Act.

It is also important that "securities-like" instruments such as options and futures be regulated. All activities conducted by the securities affiliate should be regulated by the SEC or the CFTC. However, to the extent that the banking organization is involved in such activities, an appropriate role should be carved out for the Federal Reserve Board, in addition to, and not in place of, the role of the SEC.

6. Waiver Of Examination And Capital Requirements

The bill provides that a bank holding company that is 80 percent in the securities business will not be subject to capital and examination requirements. A bank holding company so structured poses a greater risk to its affiliate banks and the deposit insurance system. Such a bank holding company should surrender its charter federal safety net and be treated as what it is: an investment bank.

7. Preemption Of State Law

The bill preempts state law with respect to any state law prohibitions on affiliations between banks and companies that underwrite, deal in or distribute securities of any type. The bill should instead apply federal banking law activities prohibitions to any state-chartered bank and thrift holding companies and then to depository subsidiaries which contain one or more federally-insured banks or thrifts.

B. Wirth-Graham

1. Summary Of The Wirth-Graham Bill

Inspired by the President of the Federal Reserve Bank of New York, E. Gerald Corrigan's report on "Financial Market Structure: A Longer View," Senators Tim Wirth (D-Col.) and Robert Graham (D-Fla.) have introduced S. 1891, the "Financial

Services Oversight Act." This bill divides the economy into three classes: bank holding companies, financial holding companies and commercial holding companies and creates extraordinary new federal regulatory authority over these three institutions, except for the insurance industry, which continues to be regulated by the states. The bill also eliminates the grandfather status of nonbank banks.

Bank holding companies are defined in the bill as any company which controls any other company that holds accounts insured under the Federal Deposit Insurance Act or title IV of the National Housing Act. Financial holding companies are defined as any companies other than bank holding companies that control any other company that offers transaction accounts. They could offer uninsured transaction accounts but would not be eligible for federal deposit insurance. Commercial holding companies are those companies other than bank holding companies and financial holding companies that control any other company engaged in financial activities, as defined by the Oversight Commission.

Most importantly, the bill creates an umbrella supervisory structure with extraordinary new powers to regulate the new framework, called the Financial Services Oversight Commission. The duties of the Commission are to:

> (1) promulgate regulations defining the types of activities in which bank holding companies, financial holding companies, and commercial holding companies may engage;
>
> (2) take appropriate action to enforce compliance with such regulations either directly or through referrals to primary regulatory agencies;
>
> (3) establish minimum standards of capital adequacy for financial holding companies and their affiliates;
>
> (4) coordinate its activities with the rulemaking and enforcement activities of other Federal agencies and state agencies; and
>
> (5) promulgate regulations to ensure that transactions between financial services subsidiaries of all holding companies are conducted in a manner consistent with the purposes of this Act."[11]

Clearly then, the bill creates a staggering increase of federal regulatory authority over the economy. Under the bill, the Commission would have the power to prescribe permissible activities of companies in the first two groups and have some power over companies in the third, like General Motors because of its motor vehicle financing activities, even though GM does not offer transaction accounts. There is no description in the bill, however, about how the Commission would carry out its statutory mandate.

Finally, the Act creates the National Electronic Payments Corporation to provide funding needed to modernize the electronic payments system, to provide for improved regulation of liquidity balances in Federal Reserve banks, to improve the telecommunications system and to prescribe procedures regarding the operations of the payments system. Access to the payments system and some undefined access to the Federal Reserve discount window would be provided to financial holding companies.

2. Deficiencies

(a) Illusory Promise Of A Two-Way Street

The Wirth/Graham bill starts from the premise that the separation of banking and commerce has been good for the U.S. economy. Thus, the bill attempts to expand the definition of banking to include all kinds of financial activities, including securities underwriting, while maintaining that financial activities can be kept separate from commerce.

At the same time, the bill promises a two-way street, that commercial bankers will be able to offer investment banking services while investment bankers will be able to also operate commercial banks. Because of the limited modification of the Bank Holding Company Act, affiliations of many existing securities firms, as under the Proxmire/Garn bill, would prevent them from benefitting from this bill, even if they were interested in doing so. Also, the benefits from being a financial holding company do not appear at all to match the advantages being bestowed upon a bank holding company. For a securities firm to take advantage of either option, it would have to sever all of its connections with commercial firms. For example, it appears as if General Electric would have to be spun off by Kidder Peabody. Therefore, a principal defect of the Proxmire/Garn bill also is present here: it permits the banking industry to invade the businesses of others one or a few at a time. A list of some of the publicly-known affiliations of securities firms appears in Appendix V-A.

(b) No "Firewall" Provisions For Protection Of Federal Safety Net Or Fair Competition: The Universe Of Risk Supported By The Federal Safety Net Is Vastly Expanded

The Financial Services Oversight Act includes no interaffiliate restrictions, and thereby abdicates Congressional guidance on a major public policy issue, namely how to protect the safety of our federally-backed banking system without extending the federal safety net to non-banking activities where they have not been and are not now needed. There is also no direction on limiting bank advantages from being unfairly used in non-banking activities. Such important decisions are left to regulators.

Bank holding companies obtain a wide swath of new non-banking power under this bill. However, by allowing affiliates of insured depository institutions to engage in all types of financial services, the universe of risk supported by the federal safety net is vastly expanded. The real question is why we as a nation need to expand the circle of risks undertaken by federally-supported banking organizations when providers of financial services other than those in the traditional intermediation process have successfully functioned without such federal support?

Even as Senator Wirth introduced his bill, he reserved the right to alter the proposal as "we [the Senate] proceed through the deliberative process." As he introduced his bill on the Senate floor, he stated:

> In addition, it is clear to me that we need to address the financial safety net in its entirety, and this proposal does not do so. As financial services become more integrated there will be increased pressures on the existing Government guarantee programs. This is a vital problem that Congress must soon address.[11]

"Addressing the financial safety net in its entirety," however, is the most important prerequisite to the consideration of any legislation that increases the universe supported by the federal safety net and Congress should not delegate this issue to a council of regulators. Our present systems should first be rationalized, before any increase in risk for the federal safety net is considered.

In summary, the Wirth-Graham bill addresses neither the question of how to restrict interaffiliate dealings to preserve the objectivity of banks at the core of our economy as the objective lender of credit nor the question of how Congress intends to keep the scope of coverage of the federal safety net from reaching all of these new activities. Thus, the Financial Services Oversight Act provides virtually no guidance about how to restructure our financial institutions to meet the challenges of the future. It simply delegates this task with little guidance to a "Council of Wise Regulators."

C. The Depository Institution Affiliation Act

Of the three bills that would repeal the Glass-Steagall constraints on affiliations between banks and securities firms, S. 1905, the Depository Institution Affiliation Act (the "DIAA"), the D'Amato- Cranston-introduced bill, is the only one that would not on its face leave securities firms at a severe competitive disadvantage vis-a-vis banks. Unlike S.1886, the Financial Modernization Act of 1987 and S.1891, the Financial Services Oversight Act, which do nothing to eliminate Bank Holding Company Act restrictions on affiliations between banks and non-financial enterprises, the DIAA renders both the Glass-Steagall Act and the Bank Holding Company Act inapplicable to depository institution holding companies ("DIHCs"), thereby permitting a Kidder Peabody, for example, to affiliate with a bank notwithstanding General Electric's ownership of Kidder. Thus, unlike S.1886 and S.1891, the DIAA's repeal of Glass-Steagall is a two-way street, because it also eliminates the affiliation restrictions of the Bank Holding Company Act.

If the Glass-Steagall Act is to be repealed by Congress, the proposal embodied by the DIAA is the only one before this Committee that would create a truly level playing field. The activities that would be conducted on that field, however, would be a species of rugby, with huge players vying against each other at significant risk to each other's safety and soundness. Freed of the ownership constraints of the Bank Holding Company Act, banks, as well as securities firms, could be absorbed into huge holding companies involved in insurance, real estate, banking, securities, retail and other commercial businesses. If the expansion of the circle of risks which might result from allowing banking organizations to engage in the full range of securities activities is large, the corresponding danger to the federal safety net posed by the formation of "superbanks" as contemplated by the DIAA is truly mind-boggling. Can any firewall contain the risk to the federal safety net behind the banking part of the organization?

A proposal as bold and far-reaching as the complete demolition of all restrictions on mixing commercial and bank activities calls for completely airtight isolation of the holding company's bank holding complex's operations from all other operations. Any crack in the insulation would result as a practical matter in federal subsidy and insurance of the entire spectrum of commercial activities, a radical departure from traditional notions of capitalism and one this country certainly cannot afford.

The DIAA falls considerably short of providing an impregnable internal wall surrounding the banking and securities components of its proposed depository institution holding company, and has other deficiencies. Among the major gaps are the following.

1. Inadequate Isolation Of Banking Activities From Non-Banking Activities

The bill precludes insured banks and institutions from directly engaging in the dealing, underwriting or brokerage of most securities, but permits such activities within the bank with respect to obligations of the United States. The bill also precludes insurance underwriting and real estate investment and development within the bank. This does not go far enough. All securities activities, including those involving U.S. government and agency obligations and general obligation bonds, and all securities-like activities, are inherently risky and have nothing to do with traditional banking activities. They therefore should be segregated in a separate, isolated subsidiary of the holding company. The bill not only permits some securities activities directly within the bank, but apparently permits all activities, including securities, insurance and real estate, to be conducted in a bank's own subsidiary. This provides no meaningful separation of the bank from such activities, since a parent is not likely to stand by idly if its subsidiary runs into difficulties.

2. Additional Capital Requirements

The bill gives federal regulators discretionary authority to require insured banks or insured institutions controlled by DIHCs to maintain additional capital up to three percent of such bank or institution's assets. Added capitalization to buffer against added risk is a good idea, but it should not be left within the discretion of regulators. Here, as elsewhere, Congress must take control by providing definite, self-operative standards.

3. Inadequate Restrictions On Interaffiliate Transactions

Despite the virtually limitless types of affiliates that would be allowed to be under common ownership and control with a bank, the bill specifies few restrictions on interaffiliate transactions. Instead, the bill authorizes federal regulators to adopt such rules and regulations as are deemed necessary to prevent a DIHC from engaging in unsafe or unsound practices.

This leaves bank regulators, rather then Congress, in charge of national financial policy. The burgeoning number of loopholes created by such regulators in the Glass-Steagall Act, which prompted Congress to impose the banking moratorium, demonstrate that regulators on their own will not adequately police the safety of insured banks. In addition, the "safety and soundness" standard is too limited; self-operative prohibitions on unfair competition by DIHCs through misuse of the federal subsidy and other bank advantages should be imposed.

Although the bill makes sections 23A and 23B of the Federal Reserve Act applicable to transactions involving insured banks within a DIHC, it authorizes bank regulators, by rule, regulation or order, to exempt a DIHC or class of DIHCs from those proscriptions and any other proscriptions on interaffiliate transactions. Given recent experience with bank regulators, this may effectively gut Sections 23A and 23B. The regulators would not even be required to be imaginative in creating loopholes; the bill actively encourages their creation.

The bill prohibits DIHC bank affiliates or other federally insured affiliates from extending credit to any securities affiliate or subsidiary thereof, purchasing assets of a securities affiliate or subsidiary thereof, issuing guarantees, acceptances or letters of credit for the benefit of a securities affiliate or subsidiary thereof, or extending credit to any investment company advised by or the shares of which are distributed by a securities affiliate. By implication, a bank or other federally-backed institution may extend credit, purchase assets from and otherwise engage in transactions favorable to any non-securities affiliate.

Since under the DIAA there would be no restrictions on the type of business conducted by bank affiliates, this effectively lets the genie out of the bottle and confers the benefit of bank advantages to all sectors of the economy, with concomitant additional strain on the federal safety net. The bill does contain a general proscription on the extension of the benefits of federal deposit insurance coverage to non-insured units of a DIHC, but this is a vague proscription and it is unclear how it would be read in conjunction with the more limited specific proscriptions applicable only to securities affiliates. In addition, there are bank benefits other than deposit insurance that must be isolated as well. For example, non-banking affiliates should not be allowed to clear on Fedwire and CHIPS.

The bill prohibits banks or insured institutions from using their credit facilities to enhance the marketability of securities underwritten or distributed by a securities affiliate, to facilitate the purchase of such securities, or to pay debt service on such securities. Again, the limitation of these provisions to securities and securities affiliates is illogical and dangerous. The application of bank advantages and extension of bank risk implicated in making credit available for the financing of an automobile sold by a manufacturing affiliate, for example, raises identical safety and soundness, conflict of interest and unfair competition concerns and should likewise be prohibited.

4. Cross-Marketing Provisions

The bill preempts all federal and state law restrictions on cross-marketing of services. This will encourage consumer perception that the entire DIHC organization is supported by the federal safety net, and will promote tie-ins of services and other forms of unfair competition.

5. Grandfathering Provisions

The bill grandfathers all interaffilate transactions approved by federal bank regulators prior to enactment of the bill. It is unclear whether this grandfather clause applies to specific transactions or to classes of transactions. In either event, grandfathering of interaffiliate transactions is inconsistent with the need to bolster the internal wall surrounding federally-backed banking organizations in light of the dramatic increase in risk exposure attributable to the demolition of the external wall between banking and commerce. In addition, grandfathering creates inequitable disparities in treatment and runs counter to fair competition.

6. Study Of Effects

The bill sets up a standing committee to study and make recommendations with respect to legislative or regulatory actions to permit better oversight of banks and thrifts, including the hiring of additional examiners. This committee will make these studies after the horse has been let out of the barn. Regulatory supervision is already considered inadequate by many; therefore, the logistics of regulating a DIHC that engages in multiple businesses would be nightmarish. What is needed is a special committee of Congress that will study the impact and risks of permitting banks and commercial firms to affiliate, before any such steps are taken. On the other hand, this bill at least does hold out the possibility of equal treatment of all parties. Whether it can be accomplished in reality remains to be seen.

These deficiencies in the DIAA are substantial, and counsel against its enactment in its current form. Glass-Steagall has created a fair and relatively safe division of activities between banks, securities firms, and other businesses. These divisions should not be discarded. If they are, however, they should be replaced with a structure that is likewise fair and safe. Of the bills before the Committee, only the DIAA fulfills the first requirement. Whether sufficient protection can be built in to provide assurances as to the second requirement remains to be seen.

VI. COMPREHENSIVIVE PLAN TO TEST FIREWALLS INTERNAL TO A BANKING ORGANIZATION AND TO PROMOTE BANK SAFETY AND FAIR COMPETITION

SIA believes that the present situation regarding the conduct by banking organizations of certain financial services and non-banking activities and regulatory policy for banking organizations is unsatisfactory, particularly in regard to the risk presented to the federal safety net and the unfair bank competition in non-banking activities. SIA proposes a comprehensive plan for restructuring the present securities operations of banking organizations to promote bank safety and fair competition and to facilitiate the consideration of future changes in the structure of the financial marketplace in safety.

A. Summary

1. Congress should ensure its continuing control over the setting of national financial policy for all units of bank and thrift holding companies containing federally-insured depository institutions and for federally-insured banks and thrifts. Concurrently, it should ensure that federal regulators do not have power to extend non-banking powers to banking organizations.

2. Congress should compel banking organizations to remove all present securities and securities-like activities from the bank and to place them in a securities affiliate separate from all other units of the holding company. Such activities should be principally overseen by the SEC.

3. Congress should erect a strong firewall between the securities affiliate and the rest of the banking organization and test whether an internal firewall can work to reduce unfair bank competition and unnecessary risk to the federal safety net. The firewall would not permit any transactions between, with or among other members of the holding company for any purpose beyond the supply of initial equity capital.

4. While the firewall is being tested, Congress should continue its comprehensive review of why, whether, how and if the relationships of banking and other financial and commercial organizations should change. Ideally, a special committee would be drawn from the Senate and House Banking Committees and the House Energy and Commerce Committee to conduct the kind of review needed for a subject so complex and so significant. Implications of bank ownership and underwriting of corporate debt and equity should be explored.

5. If the restructured banking organization with a strong firewall around the securities operations does in fact

work, Congress can then with confidence consider further steps, which could include the complete elimination of the Glass-Steagall and Bank Holding Company Acts.

Under this plan, the possibilities of change can be explored with safety, without risk. Since no one knows if a firewall internal to a banking organization can work, Congress should safely test the concept out. If it does not work, no harm will have been done and risk to the federal safety net and unfair bank competition may have been somewhat reduced.

Only this plan is truly comprehensive, because it deals with the existing situation, yet looks forward to full consideration of all of the alternatives that might be presented. Significant questions of national policy are obviously involved. By taking these steps carefully, one at a time, and not being rushed where there is no need for it, Congress can ensure that national financial policy is controlled and directed in a manner best for the nation, its businesses and its citizens.

B. The Suggested Restructuring Of Banking Organizations Is Designed To Reduce Taxpayer Risk And Unfair Bank Advantage From Existing Bank Securities Activities While Examining The Benefits And Detriments Of Changes In The Structure Of The Financial Marketplace

1. Continuing Congressional Control Of National Financial Policy Should Be Ensured

Congress in the Competitive Equality Banking Act reacquired control over the setting of national financial policy and stopped bank regulators from enlarging the powers of bank and thrift organizations in securities, real estate and insurance. Glass-Steagall was specifically made applicable to federally-insured thrifts and banks. Legislation should ensure that Congress continues its control over such policy decisions.

The limits set by Congress would apply to all units of a bank or thrift holding company which have at least one institution with federal deposit insurance in the complex. Opportunities for regulators and state legislatures to reacquire such control should be eliminated. Loopholes which regulators assert exist in present laws should be closed; for example, the "engaged principally" loophole recently discovered in the Glass-Steagall Act by the Federal Reserve Board; the Federal Reserve Board's apparently new view that the Bank Holding Company Act's limitations on powers do not extend to state-chartered bank subsidiaries and their subsidiaries (the recent Indiana insurance decision); and the "bank assets" and "bank securities" loopholes recently identified by the Comptroller of the Currency.

Since the international activities of bank holding companies can adversely affect the federally-insured American banks and since international securities affiliates also enjoy the benefits of insured deposits and the federal safety net, the policy control of Congress and the structure proposed in this plan should apply to the overseas securities operations of American bank holding companies.

2. All Of The Present Securities And Securities-Like Businesses Of A Banking Organization Should Be Placed In One Or More, Completely Segregated, Separately-Capitalized Securities Affiliates Solely Devoted To Such Activities. The Regulatory, Tax And Accounting Treatment Of A Securities Affiliate And Its Securities Holdings And Activities Should Be Identical To That Of A Broker-Dealer

The existing securities (including "securities-like" activities, e.g., options, futures) activities of a bank, thrift or bank holding company (which in this plan includes a thrift holding company) and of all of its affiliates (collectively referred to as the "bank holding company complex" or "family" or "banking organization") should be isolated in one or more nonbank "securities affiliates" (hereinafter referred to in the singular) but not as a subsidiary of any bank. The securities affiliates could themselves be organized in a sub-holding company arrangement: a securities sub-holding company could own all of the interest in one or more securities affiliates.

There would be no restrictions on dealings among members of the securities sub-holding company group. The securities affiliates would take over all of the banking organization's securities activities, domestic and international, except trust and pension management (but including, e.g., underwriting, dealing, trading in U.S. government and agency obligations and municipal general obligations and permitted revenue bonds; all agency activities such as brokerage, merger and investment advice and private placements; foreign exchange, options, futures, permitted commodities and any other activity that if carried on by a U.S. non-banking organization would be required to be carried on by an SEC-registered broker-dealer).

The securities affiliate should be regulated as a broker-dealer on the state and federal levels, as well as by one or more of the existing self regulatory organizations (e.g., the NYSE and the NASD). The SEC would be the principal regulator for all securities activities; U.S. government securities activities would continue to be subject to the oversight of the Federal Reserve Bank of New York as at present. Securities trading portfolios should be in the securities affiliate to ensure that tax treatment is the same as for broker-dealers. (Banks should hold securities only as presently permitted for investment, but these should be restricted to reasonably short-term investments to avoid portfolio risks.) Inventories of the securities affiliate would be required to be marked-to-market as is required for a broker-dealer. The securities-like activities would be regulated by the CFTC or the SEC, as the case might be.

No distribution of securities or "securities-like" activities (e.g., options or futures) should take place in, by or through a bank or any other affiliate. Any interpretative decisions as to what is a security or what security like instrument or activity to be handled by the securities affiliate and not by any other affiliate should be made by the SEC and not by any banking regulator (even if the CFTC would be the appropriate regulator).

The standard might be that any instrument, transaction or activity that is "closely related" to securities or securities-like activities is to be within the province of the securities affiliate. In other words, a bias should be created by Congress in favor of placing securities and securities-like activities outside of the federal safety net in securities affiliates insulated from the rest of the banking organization for reasons of bank safety, taxpayer risk and fair competition.

3. A "Firewall" Should Be Erected Between Other Members Of The Bank Holding Company Complex And The Securities Affiliate

(a) Permanent Separate Equity Capital Should Be Provided To The Securities Affiliate, But Only To The Extent Net Capital Of All Banks Within The Banking Organization Can, Without Counting Such Capital, Be At Least At A Level Of 6% Of Assets

The equity and other capital of the securities affiliate would be solely dedicated to its operations. Only initial equity should be made available to the securities affiliate by the banking organization, and then only to the extent it can be done without lowering the net capital of affiliated banks below 6% of assets. Subsequent equity and all other capital needs should be obtained outside of the banking organization. The recent Continental Illinois and First Options situation demonstrates the need for this requirement.

(b) The Securities Affiliate Should Be Required To Obtain Its Credit From Entities Outside Of The Bank Holding Company Complex

Creation of the separate securities affiliate alone will not provide the required insulation. Many of the pre

Glass-Steagall abuses involved transactions between banks and their securities affiliates. The availability of credit is often as important as its terms; a prohibition on preferential treatment in decisions to grant credit is impossible to police. Third party credit judgments should be made in every case where a securities affiliate wants funds, as is the case when a securities firm seeks credit. The bank holding company complex with its federal safety net should not be allowed to rescue a securities affiliate, on any terms.

(c) If A Securities Affiliate Is Participating In A Financing, No Affiliate May Participate (E.g., As Supplier Of A Letter Of Credit Or Short Term Financing), And Vice Versa

A significant unfair advantage for a bank is its ability to tie its credit facilities to its underwriting or other securities services. Existing prohibitions against tying arrangements in the Bank Holding Company Act are ineffectual. An "intent" test is unworkable. For example, if a securities affiliate is advising with respect to a merger or is seeking to underwrite a housing revenue bond, bank financing or a bank credit facility should come from an unaffiliated bank. If an affiliated bank is supplying a credit facility in connection with a transaction, the securities affiliate would not be allowed to engage in the transaction (e.g., if an affiliated bank is supplying a letter of credit for a debt issue or "bridge" financing in a buyout, the securities affiliate may not participate as an underwriter or advisor or placement agent.)

(d) The Securities Affiliate Should Not Be Permitted To Have Business Dealings With Any Member Of The Bank Holding Company Complex; It Should Be A Completely Separate Pocket

No securities affiliate should be allowed to perform securities services for a bank or other entity with which it is affiliated, such as underwriting, dealing or market making, handling private placements, buying or selling securities to or handling executions for an affiliate (including its trust and pension accounts), providing investment, merger or private placement or other securities advice or packaging, or underwriting and distributing loans originated by an affiliated entity. No transfer of assets between a securities affiliate and the other units of a bank holding company complex should be allowed. No securities affiliate should be allowed to participate in the distribution of securities originating with any other unit of the holding company complex. Joint marketing and cross-marketing with other members of the bank holding company complex should be forbidden so that no trade off of the aura of protection afforded by the federal safety net can take place. The securities affiliate should go elsewhere for its customers as it should for its credit. Affiliates of the securities affiliate should not be allowed to provide services or products for the securities affiliate; this separation from the business of the bank holding company complex is necessary to avoid the unfair shifting of costs, conflicts of interest and unfair advantage and to encourage competition.

(e) If The Securities Affiliate Is To Operate Under Its Own Authority And By Its Own Skill And Stand On Its Own, It Should Have Its Own Personnel And Systems And Should Not Benefit From Customer And Other Valuable Data Constantly Flowing Into And Developed By Its Affiliated Banks

There should be no commonality of personnel between a securities affiliate and any affiliated bank. Officers and employees in common should not be permitted. Exchange of non-public information between a securities affiliate and affiliated companies should not be permitted. If directors in common with the bank holding company are to be allowed, appropriate restrictions to ensure the necessary separation should be imposed. There should be no common operation of computer and similar systems. To ensure the adequacy of a securities affiliate's personnel, systems and controls, the securities affiliate should not commence business until it has been audited in these areas by its designated examining authority (e.g, the NYSE or the NASD).

(f) A Securities Affiliate Should Not Be Permitted To Trade On Identification With The Bank Portion Of The Complex

It is clear from past experiences (for example, with real estate investment trusts during the 1970s) that the public can easily be confused or misled into believing that bank credit is behind the operations of an affiliate. Fine print in advertising is not enough. Such misunderstanding should be avoided to insulate federally insured bank funds, to prevent unwarranted runs on affiliated banks and to prevent an unfair benefit of credit identification from being conferred upon the affiliate. Therefore, a securities affiliate should have a separate and distinguishable name and not be advertised as associated with the bank affiliate, directly or indirectly, so as to suggest credit responsibility in the public's mind. Walter Wriston believed that if a bank's name is on the door, the bank will fly to the rescue of an affiliate in trouble. At least, the name on the door should be different.

For the same reason, the securities affiliate should not share premises with any member of the holding company complex.

(g) A Securities Affiliate And Any Of Its Affiliates Should Not Be Allowed To Have Any Dealings In Common With A Customer

A major problem to be avoided here is the shifting of risk from an affiliated bank to the public through the activities of a securities affiliate. The most obvious example would be where a securities affiliate creates and sells commercial paper to pay off a loan made by an affiliated bank. A bank should not be allowed to make a loan to facilitate a securities transaction for a customer of the securities affiliate. Detailed rules will have to be developed.

(h) Securities Affiliates Should Not Be Allowed To Clear On Fedwire And CHIPS Through Affiliated Banks

A securities affiliate should not be allowed to clear though an affiliated bank; this would give the bank holding company complex an unfair cost and profit advantage.

(i) Adequate Provisions Dealing With Tying, Self-Dealing, "Back Scratching," Unfair Advantage, Improper Utilization Of Credit Facilities And Assets Of An Affiliated Company In Addition To Those Specifically Mentioned Would Need To Be Developed

Banks are known for reciprocal dealing. Therefore, care will have to be taken to prevent a banking organization from engaging on a reciprocal basis with other banking organizations' securities affiliates to circumvent the firewall provisions.

(j) There Should Be Substantial Penalties For Violations And Individual Liability Of Involved Officers And Other Employees; Standing Should Be Conferred On Individuals And Firms To Sue, With The Award Of Attorney' Fees If Successful, For Damages, For Injunctive Relief And To Force Divestiture Of Securities Operations If The Structural Prohibitions Are Not Observed. Private Enforcement Against Regulatory Decisions Should Also Be Provided

There should be incentives and mechanisms for compliance so that the framework will work as designed. Without such provisions, there would be no hope that the restructuring could work. The urge of the parent to save its offspring would be too strong; despite rules, Continental Bank went to the aid of its failing First Options subsidiary. A major problem with the

Glass-Steagall Act, a criminal statute, now is that there is no effective enforcer; no U.S. attorney or bank regulator appears interested.

Persons who consider themselves aggrieved by interim or final, oral or written, decisions of federal banking or other regulators dealing with securities or securities-like instruments or activities should be allowed to challenge such decisions in court. Personal liability for failure to apply the law should be considered.

4. Once Congress Has Assured Its Continued Control Over The Setting Of National Financial Policy In These Areas And The Restructuring Of Present Securities Operations Has Been Provided For, Congress Should Continue Its In-Depth Comprehensive Review Of The Best Course To Follow With Respect To The Banking System And The Financial Markets Of The Nation And The World, Including The Further Entry Of Banks Into Real Estate, Insurance And Securities Activities And The Complete Intermingling Of Banking And Commerce. To Assist Congress In Evaluating These Complex And Important Matters, Congress Should Establish A Special Committee

It is clear that the problems and questions pertaining to the separation of commercial and investment banking and of banking and commerce are extremely complex and cannot be adequately dealt with in the usual hearing process. As Congress has done at other times when it had extremely difficult and complicated problems to solve, it should create a special committee or commission drawn from House and Senate Banking Committees and the House Energy and Commerce Committee. The committee should be separately staffed and have the sole mandate of developing sound and sensible arrangements for the financial future of the nation and the world. For example, the regulatory apparatus of the nation and the world needs improvement: does it make sense for the SEC not to have jurisdiction over financial futures and options when they are so interrelated with the securities markets? In addition, the lack of consistent international approaches leads to "lowest common denominator" contests developing: securities may be issued in one country rather than another because of less strict disclosure requirements. Also, if one country allows universal banks to develop, but others do not want that result for themselves, will the pressures from that one country ultimately prevail against the contrary judgment of other countries? What is the best way to ensure the continuation of competitive securities markets and to preserve the essential role of the bank as intermediary? What are the implications of banking organizations getting involved in the ownership and trading of corporate securities? The risks associated with long-term corporate debt and equities are obvious. Of overriding concern, however, are all of the problems of bank control of American business and conflicts of interest which would surface if banks can own, underwrite and deal in corporate positions, particularly long-term bonds and equities. These questions have not been examined by Congress since before 1933.

Similar questions surround any other grant of non-banking powers to banking organizations. Should banks be allowed to enter other businesses, one by one, securities, insurance, real estate, the rest to follow? Can the division between banking and commerce be discarded altogether? Some questions that should be considered are set forth in Appendix VI.

5. If The Restructured Banking Organization With A Strong Firewall Around The Securities Operations Does In Fact Work, Congress Can Then With Confidence Consider Further Steps, Which Could Include The Complete Elimination Of The Glass-Steagall And Bank Holding Company Acts

Can a firewall internal to a banking organization can be an adequate substitute for the Glass-Steagall and the Bank Holding Company Acts? The firewall must ensure that unfair bank competition can be avoided and that the federal safety net is not extended to back any non-banking activities. If the internal firewall works, then the elimination of the entire separation between banking and commerce can be considered, certainly the fairest of any of the alternatives under discussion. Since no one knows if an internal firewall can prevent risk to the federal safety net from being extended and avoid unfair bank advantage in non-banking activities, this plan provides a way to test the concept in safety. If the firewall does not work, no harm will have been done, no risks unnecessarily run.

VII. SUMMARY

The division between banking and securities operations, and the larger division between banking and commerce of which it is a part, have been, together with federal deposit insurance, the keystones of the integrity of our banking system. The Glass-Steagall Act and federal deposit insurance have had a symbiotic relationship since their common birth in the Banking Act of 1933. Federal deposit insurance maintains consumer confidence in banks and enables banks to perform their vital financial intermediation functions at a subsidized cost. The Glass-Steagall Act exists ensure that the risks and benefits of the federal safety net are limited to those inherent in this traditional function of banks of pumping credit into the rest of the economic body.

Separation of these two symbiotic watchdogs of our financial structure would be a mistake with serious consequences. The Glass-Steagall Act is as valuable today as its contemporaries, the Securities Act of 1933 and the Social Security Act. Thanks to the Glass-Steagall Act, we today have a strong, independent securities industry which has suffered but survived the October financial market collapses, and a banking industry with limited exposure to such risk and volatility to which depositors can turn with confidence in troubled times. This is no time to shake up a system that has worked so well.

Denial of common ownership of banking and non-banking commercial activities is perhaps the only, and certainly the best, method of confining risk to the federal safety net to bank banking activities. Such separation is also essential to fair competition. Federally-backed organizations, with their numerous advantages, should not compete with their customers.

Safety and fairness thus counsel against tearing down the Glass-Steagall wall, and there are no compelling reasons to do so. Banks continue to be profitable in their traditional lending activities. By contrast, the securities industry is retrenching, and profits are subject to wild swings. Previous attempts to make banks or thrifts more robust by expanding their permissible spheres of activity have had counter-productive results. Technology and globalization have linked risks internationally and have made securities activities far more hazardous. Contrary to their claims, U.S. banks continue to outperform foreign banks, such as the Japanese. Any diversification of bank activities will divert banks from their irreplaceable role as intermediaries to the detriment of consumers.

In light of these factors, the Glass-Steagall wall should be bolstered, not weakened. Existing exceptions and loopholes should be eliminated. If Congress is intent on considering new powers for banks, it should do so by restructuring the present organizational structures of bank and thrift holding companies, using existing securities powers as a test of whether a separate securities affiliate can be effectively isolated from its bank affiliate. The intra-organizational "firewall" can thus be tested without adding risk to the system; it may well reduce the unnecessary exposure of the federal safety net and unfair bank advantages in activities that do not pertain to their core functions.

While this internal firewall is being tested, Congress should keep control over national financial policy by eliminating the ability of bank regulators to erode the Glass-Steagall and Bank Holding Company Act divisions. A Congressional special committee could conduct a comprehensive review of proposed new powers, including the underwriting of corporate debt and equity, to evaluate risks, conflicts and unfair competition associated with the breakdown of the division between banking and commerce.

If the firewall works and such policy questions are favorably resolved, Congress could then end the division between commerce and banking all at once, rather than employing a piecemeal approach. Any other approach, such as those proposed by S. 1886 and S.1991, could result in bank domination of other financial sectors, needless escalation of risk for the American taxpayer and economic stagnation.

FOOTNOTES

1/ Lawrence R. Klein, "Policy Making In Global Financial Markets, June 15, 1987.

2/ *The Wall Street Journal*, December 1, 1987.

3/ "Real Estate Powers for Banks", *American Banker*, November 13, 1987 p. 1.

4/ *American Banker*, October 21, 1987.

5/ *Recent Innovations in International Banking*, Bank for International Settlements, April 1986.

6/ *The Christian Science Monitor*, November 27, 1987, Appendix III-B-7(2).

7/ Testimony before Subcommittee on Commerce, Consumer & Monetary Affairs, Committee on Government Operations, United States House of Representatives, June 11, 1986, pp. 31-32.

8/ Federal Reserve Bank of New York, Staff Study, p. 16.

9/ Federal Reserve Bank of New York, Staff Study on Recent Trends in Commercial Bank Profitability, p. 337.

10/ *The Washington Post*, "After 'Big Bang' a Big Shakeout," September 27, 1987.

11/ Staff of House Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee on Energy and Commerce, 99th Cong., 2d Sess., "Report on Restructuring Financial Markets: The Major Policy Issues," 99-DD (Comm. Print 1986).

12/ Salomon Brothers Inc., *The Japanese Banks*: *Positioning for Competitive Advantage*, November 1986.

13/ CRS Report for Congress, "Financial Institutions: Problems and Restructuring," June 29, 1987, p. 115.

14/ *The Washington Post*, October 20, 1987.

15/ *The Washington Post*, October 21, 1987.

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[illegible]/ Id.

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[illegible]/ Mandate for Change, Federal Deposit Insurance Corporation, October 1987, p. 70.

[illegible]/ Section 103(a).

[illegible]/ 133 Cong. Rec. S16676 (daily ed. November 20, 1987) (statement of Sen. Wirth).

APPENDICES

STATEMENT OF SECURITIES INDUSTRY ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

DECEMBER 8, 1987

APPENDIX III-B-1(1)

NET INCOME, PROVISIONS, INCOME TAX AND PROFIT AFTER TAX OF COMMERCIAL BANKS

(per cent of average balance-sheet totals - average 1980-1985)

	Net Income	Provisions (net)	Income Tax	Profit After Tax
	Over 1.25			
Spain	1.71	1.00	0.18	0.53
Italy	1.52	0.76	0.42	0.34
United States	1.35	0.44	0.21	0.70
Portugal	1.33	0.83	0.06	0.44
	Between 1.00 and 1.25			
Canada (1982-85)	1.23	0.53	0.17	0.53
Sweden (1981-85)	1.15	0.77	0.16	0.22
Germany	1.13	0.54	0.33	0.26
Switzerland	1.09	0.41	0.22	0.47
Netherlands	1.08	0.62	..	..
France	1.01	0.62	0.17	0.22
	Below 1.00			
Luxembourg	0.91	0.60	0.16	0.15
Finland	0.88	0.39	0.16	0.33
Japan	0.50	0.03	0.25	0.22
Belgium	0.36	0.01	0.15	0.20

Source: OECD Study, Bank Profitability 1980-1985

APPENDIX III-B-1(2)

INCOME STATEMENTS OF COMMERCIAL BANKS 1980/1985

TABLE 1

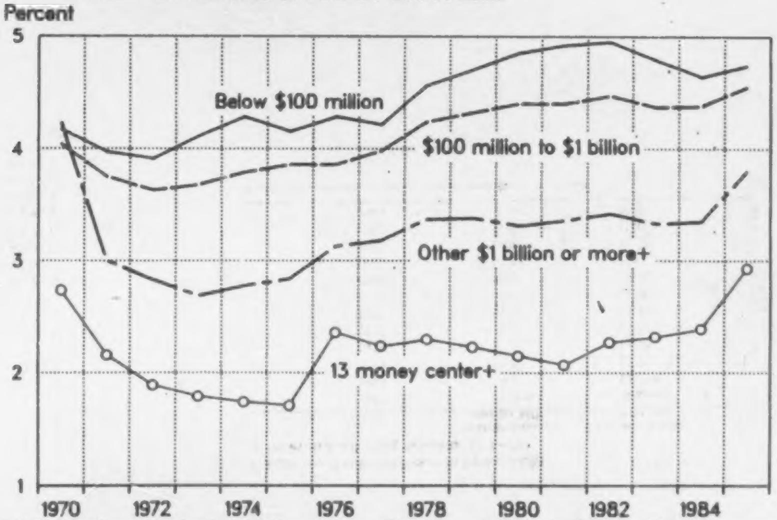
	Net Interest Income		Non-Interest Income		Gross Income		Operating Expenses	
								Per cent of average balance sheet totals
	1980	1985	1980	1985	1980	1985	1980	1985
Belgium	2.03	1.53	0.52	0.47	2.55	2.00	2.17	1.61
Canada (1)	2.24	2.65	0.62	0.82	2.86	3.46	1.96	2.00
Finland	2.28	1.70	2.07	2.31	4.35	4.01	3.39	2.88
France	2.84	2.53	0.49	0.41	3.33	2.95	2.24	2.08
Germany	1.89	2.44	0.83	1.05	2.72	3.49	2.04	2.29
Italy	3.37	3.02	0.97	1.31	4.34	4.34	2.82	2.97
Japan	1.61	1.22	0.21	0.32	1.81	1.54	1.39	1.06
Luxembourg	0.82	1.18	0.18	0.29	1.00	1.47	0.41	0.41
Netherlands	2.27	2.20	0.79	0.76	3.06	2.96	2.03	1.86
Portugal	2.69	2.41	0.99	0.75	3.68	3.16	2.02	2.16
Spain	4.32	3.82	0.87	0.91	5.19	4.73	3.56	3.03
Sweden (2)	2.15	1.99	0.89	1.07	3.04	3.06	1.88	1.89
Switzerland	1.23	1.40	1.13	1.26	2.36	2.66	1.41	1.41
United States	3.08	3.47	0.87	1.25	3.95	4.72	2.63	3.14

Source: OECD Study, Bank Profitability 1980-1985

APPENDIX III-B-1(3)

Chart 6

NET INTEREST MARGIN AS A PERCENT OF AVERAGE ASSETS*: INSURED COMMERCIAL BANKS BY BANK SIZE



* Net interest margin equals net interest income (taxable equivalent basis) less net interest expense. Data for 1985 are preliminary estimates.

+ 1984 and 1985 data are for 9 money center banks, causing breaks in the series for money center banks and other $1 billion or more.

Source: Federal Reserve Bank of New York, Staff Study, Recent Trends in Commercial Bank Profitability, 1986

APPENDIX III-B-1(4)

NET INTEREST INCOME AT SELECTED BANKS (in millions)

Bank	1986	1985	1984	% Change Since 1984
Bankers Trust	$ 911.9	$ 851.5	$ 841.8	+ 8.3%
Barnett Banks of Florida, Inc.	768.2	644.9	497	+54.6
Chase Manhattan Corp.	2,996.2	2,748.7	2,308.5	+29.8
Chemical New York Corp.	1,718.6	1,571.5	1,371.9	+29.8
Citicorp	19,224.0	19,474.0	18,194.0	+ 5.7
Continential Illinois Corp.	607.2	677.2	621.2	- 2.3
First Bank System, Inc.	686.4	640.0	523.4	+31.1
First Interstate Bancorp	2,019.0	1,935.4	1,682.7	+20.0
First Union Corp.	883.4	735.9	623.5	+41.7
Manufacturers Hanover Corp.	2,031.5	2,112.0	1,866.4	+ 8.8
Marine Midland Banks, Inc.	789.2	697.1	624.5	+26.4
J.P. Morgan & Co., Inc.	1,557.3	1,418.3	1,051.6	+48.1
NCNB Corp.	742.1	598.2	539.4	+37.6
PNC Financial Corp.	689.4	624.2	494.5	+39.4
Security Pacific Corp.	1,710.4	1,608.1	1,414.6	+20.9
Sovran Financial Corp.	523.1	464.5	402	+30.1
Wells Fargo & Co.	1,608.9	1,220.2	1,069.5	+50.4
			Average	+28.3%

Source: Annual Reports.

0424M

APPENDIX III-B-2(1)

Comparison of After-Tax Return on Equity (ROE) in Securities and Banking Industries, 1973–1984

Year	Securities Industry After-Tax ROE	Commercial Banking After-Tax ROE
1973	(3.0)%	Not Available
1974	0.7	12.59%
1975	16.6	11.75
1976	17.6	11.48
1977	6.9	11.71
1978	11.2	12.90
1979	15.6	13.90
1980	26.6	13.68
1981	19.4	13.12
1982	21.9	12.08
1983	19.8	11.12
1984	7.2	10.68

Source: Securities Industry Association and American Bankers Association

APPENDIX III-B-2(2)

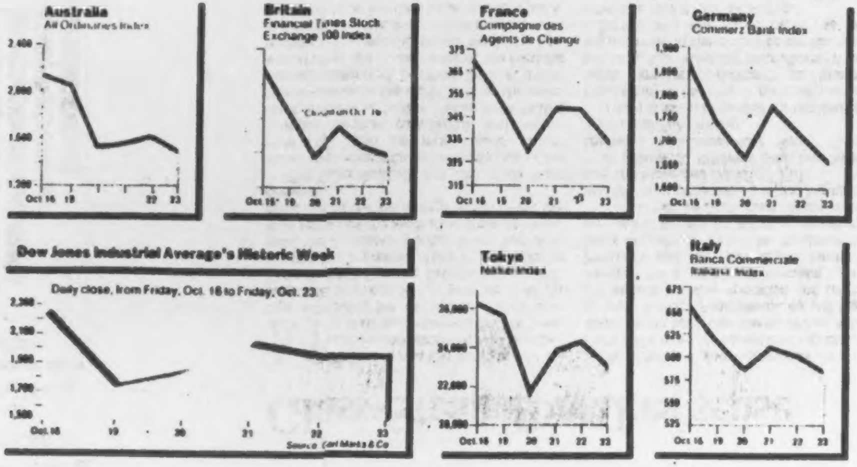
the Securities Industry, 1979–1984

Year	1Q	2Q	3Q	4Q
1979	14.5%	17.0%	19.2%	13.1%
1980	14.3	39.1	22.7	29.4
1981	26.0	23.2	8.0	21.1
1982	5.5	9.1	28.5	41.3
1983	29.9	31.2	14.8	6.0
1984	9.2	(1.8)	12.5	8.7

Source: Securities Industry Association

APPENDIX III-B-4

EFFECTS OF THE OCTOBER CRASH



Source: Carl Marks & Co

Source: The New York Times

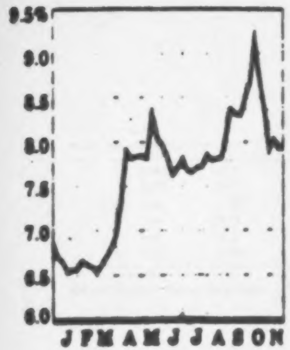
APPENDIX III-B-7(1)

WALL STREET JOURNAL - DECEMBER 4, 1987

Hard Times Hit the Municipal Bond Market

Volatility Has Frightened Investors...

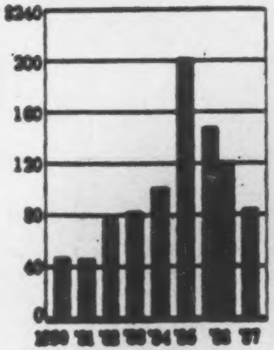
Index of yields on 20 general obligation municipal bonds
(In percent)



Source: Bond Buyer

...New Issues Have Fallen Off...

Value of new issues of long-term municipal bonds
(In billions of dollars)

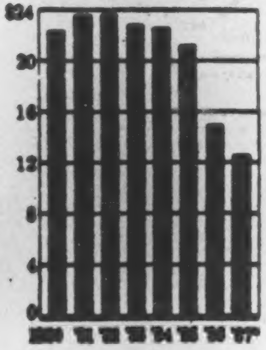


▨ Data through first 10 months

Source: Securities Data Co.

... And Underwriting Is Less Profitable

Average underwriter compensation for fixed-rate issues of $10 million or more
(In dollars per $1,000)



*Data through Nov. 20, 1987

Source: Securities Data Co.

APPENDIX III-B-7(2)

FRIDAY, NOVEMBER 27, 1987 THE CHRISTIAN SCIENCE MONITOR

Glass-Steagall makes sense

MORE than just the banking and securities industries should be closely watched following Senate hearings scheduled for early next month into proposals to overturn key provisions of the Glass-Steagall Banking Reform Act of 1933. No one has a greater stake in the outcome than the American public, which has been well served by the legislation since its enactment during the worst days of the Great Depression.

The Glass-Steagall Act has often been called the bedrock financial legislation of the New Deal. And for good reason. Glass-Steagall divorced commercial and investment banking activities. Banks were falling like dominoes in the early '30s, as the stock market plummeted. But from 1933 on, a wall was erected down the center of the banking highway: Commercial banks would be barred from the volatile securities market; securities would be handled by investment banking houses.

Now the commercial banking industry – and no small contingent of supporters, including the Reagan administration; as well as federal bank regulatory agencies – want to tear down that wall. They've won an important ally: William Proxmire, Democratic chairman of the Senate Banking Committee.

Mr. Proxmire and Republican Sen. Jake Garn have recently introduced legislation to allow banks back into the securities market by way of holding companies. By putting the investment banking operation and the commercial bank under a common parent, Proxmire and Mr. Garn argue, banks and bank depositors would be insulated from any risk or fallout during an economic crisis.

The Proxmire-Garn plan, meanwhile, is not the only proposal to allow banks back into the securities trade.

A somewhat different plan has been introduced by Democratic Sens. Timothy Wirth and Bob Graham.

There is much to be said for continued deregulation of banking – such as providing banks greater opportunity in interstate banking. But removing restrictions on banking activities in the securities market is quite different. Not one major bank has failed after the recent Oct. 19 slump.

In 1930 alone, by one count 1,352 banks crashed. In 1934, however, after Glass-Steagall, only 57 failed, by one count.

The burden of proof must be on the proponents of repealing Glass-Steagall. Unless the reasons prove to be decisive, the law, which has safeguarded the American people for more than half a century, should not be altered.

APPENDIX III-B-8

[illegible]

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ONE HUNDREDTH CONGRESS
WASHINGTON, DC 20515

[illegible]

December 1, 1987

SUBCOMMITTEE NOTICE

TO: All Members, Subcommittee on Financial Institutions Supervision, Regulation and Insurance

FROM: Fernand J. St Germain, Chairman

SUBJECT: Hearings on Reform of the Nation's Banking and Financial Systems

Continued hearings on the comprehensive reform of the nation's banking and financial systems will be held on Wednesday, December 2, and Thursday, December 3, 1987 at 10:00 a.m. in Room 2128 Rayburn House Office Building. Following is a final list of witnesses scheduled to testify at the hearings on December 2 and 3. Enclosed is prepared testimony from tomorrow's witnesses, as well as two CRS Issue Briefs on banking reform issues for your review.

PANEL

Wed. **Dec. 2** **10:00 a.m.** **2128 RHOB**	**Alan Fox**, Legislative Representative, Consumer Federation of America **Allen Fishbein**, Director, Center for Community Change **Jon Brown**, Director, Bank Watch **Mildred Brown**, President, Association of Community Organizations for Reform Now (ACORN)

PANEL

Thurs. **Dec. 3** **10:00 a.m.** **2128 RHOB**	**Frank E. McKinney**, President, Banc One Corp., Columbus, Ohio; Chairman-elect, Association of Bank Holding Companies **Charles H. Pistor, Jr.**, Chairman of the Board and CEO, First RepublicBank of Dallas; President, American Bankers Association **Charles T. Doyle**, CEO, Gulf National Bank, Texas City, Texas; Chairman, Independent Bankers Association of America

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STATEMENT ON

"FINANCIAL SERVICES RESTRUCTURING PROPOSALS"

BY

ALAN FOX
LEGISLATIVE REPRESENTATIVE
CONSUMER FEDERATION OF AMERICA

BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

HOUSE COMMITTEE ON BANKING,
FINANCE AND URBAN AFFAIRS
HON. FERNAND J. ST GERMAIN, CHAIRMAN

December 2, 1987

My name is Alan Fox. I am Legislative Representative for Consumer Federation of America (CFA) which consists of over 230 local, state and national consumer, senior citizen, rural, cooperative and labor organizations that together have over 50 million members. CFA has, since 1968, represented these organizations before Congress and federal regulatory agencies on a wide variety of matters of concern to consumers.

Financial services restructuring proposals do little to directly meet the needs of most consumers. In particular, these proposals offer no tangible benefits and pose serious risks to low- and moderate-income consumers and the communities and neighborhoods in which they live. Advocates for these proposals have made only the vaguest of promises concerning the consumer benefits of restructuring. These promises rely on two assumptions: First, that widescale mergers of different types of financial services providers into financial superfirms will somehow enhance competition, and second, that enhanced profits from engaging in new activities will trickle down to low- and moderate-income communities in the form of improved service. Only one restructuring proposal, H.R. 3209, contains any specific requirements regarding consumer services.

In contrast to these vague promises of future benefits, there are several clear dangers to consumers inherent in these proposals. The creation of financial superfirms risks further erosion of already inadequate enforcement of existing consumer protection and community reinvestment laws; excessive concentration of economic resources to the detriment of full competition; dilution of the stabilizing impact of federal deposit insurance; and continued inattention to the needs of low- and moderate-income families and communities.

If consumers are to benefit from these restructuring proposals, the benefits must be explicitly provided for in any legislation establishing that restructuring. Turning large corporations loose to merge with other large corporations will not improve consumer services, and will probably work to the detriment of many consumers. Financial restructuring accompanied with a clear set of legal, regulatory, and service requirements may answer consumer needs.

There are four general areas Congress must address in association with any restructuring proposal to ensure consumers benefit from that proposal:

1. Enforce existing consumer and community reinvestment laws. Financial services restructuring will require the federal banking agencies to invest additional resources into scrutiny of banks and their affiliates. These agencies, however, have a history of neglect of

regulatory agencies have been reduced in recent years. At a time when safety and soundness concerns are strong, these activities cannot be expected to be the agencies' highest priorities. But before these agencies are given additional responsibilities as a result of restructuring legislation, it is imperative to first ensure that they meet their current responsibilities under all the laws they are required to enforce.

2. PROTECT THE FEDERAL DEPOSIT INSURANCE SYSTEM

The most basic benefit provided to consumers and to the economy as a whole by the current structure of bank regulation is deposit insurance. Any change, structural or otherwise, that affects deposit insurance affects consumers' perceptions not just about the stability of individual institutions but of the banking and financial systems as a whole. Congress should exercise extreme care before making structural changes that could erode consumer confidence in deposit insurance.

There are three aspects to this issue that are raised by restructuring proposals:

First, Congress must guarantee that consumers, particularly small depositors, will always have available insured deposit accounts that combine absolute safety with below-market yields. Consumers understand the trade-off between safety and yield. Consumers who place the strongest value on safety have only the federal deposit insurance system to guarantee that safety will be maintained.

Second, restructuring must ensure that problems in uninsured lines of business do not affect, even indirectly, insured deposits or the deposit insurance system. As discussed more fully below, this is more than a matter of requiring different legal entities. Depositors must not be left with even the impression that their insured deposits are affected in any way by activity in uninsured lines of business.

Third, deposit insurance must not be used to provide an unfair competitive advantage to uninsured lines of business offered by firms with access to deposit insurance. Again, legal structure is not a sufficient answer. The FDIC or FSLIC emblem on the door of a bank should not be allowed in any way to carry an imprimatur of approval for uninsured business. The more similar an uninsured service is to a bank deposit, the more critical it becomes to remove any impression that the uninsured activity is insured.

Proponents of restructuring have addressed these last two issues primarily by discussing the concept of a "Chinese Wall" between the bank and the uninsured activities. Unfortunately, the discussion usually ends as soon as the phrase is uttered, or

First, the entire banking system is responsible for ens
a basic level of service in all communities. Improvements i
deposit services, through basic banking, and improvements in
credit services, through strengthening of the Community
Reinvestment and Home Mortgage Disclosure Act, should be app
across the board. Implicit in this statement is the necessi
ensure that the banking system does not become a two-tiered
system in which some institutions are obligated to meet basi
consumer needs, and others are not. We reject proposals tha
seek to relegate consumer responsibilities to a small class
financial institutions.

Second, specific banks that take advantage of new power
must be required, as a condition of exercising those powers,
be among the industry's leaders in meeting the credit and dep
needs of low- and moderate-income consumers and neighborhood
These conditions could take any of several forms. Banks coul
permitted to exercise new powers only if their past performan
as banks met certain standards. Banks could be allowed great
access to new powers if they show greater efforts at meeting
basic banking needs. Banks could also be required to structu
some new services in ways that would make those services more
accessible to more consumers.

4. ENSURE GREATER COMPETITION

Some of the markets banks might enter under restructurin
proposals could benefit from more competition. Unless Congre
ensures that restructuring will introduce new competitors,
restructuring will lead to greater concentration among financ
services generally without enhancing concentration in any
particular product or geographic market.

The experience of the past two years with interstate ban
ought to be instructive. For two years, large and medium-siz
banks have used mergers to expand interstate. Few, if any,
markets have had new competitors introduced. In fact, some
states denied consumers any chance to benefit from increased
competition by prohibiting interstate expansion through *de no*
banks.

Absent specific legal restrictions, product deregulation
will produce the same results as geographic deregulation. A
large bank that wants to enter the insurance business will no
start up a new entrant; it will buy an existing company.
Financial restructuring will simply touch off a new wave of
mergers, this time across product lines. Only the lawyers an
the accountants will benefit.

Congress should ensure that restructuring introduces new
competitors into the financial services arena. Large banking
nonbanking firms should not be allowed to merge.

TESTIMONY BY

ALLEN J. FISHBEIN
GENERAL COUNSEL

CENTER FOR COMMUNITY CHANGE

WASHINGTON, DC

on

REFORM OF THE FINANCIAL SYSTEM

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

10:00 a.m.

December 2, 1987

Good morning Mr. Chairman and members of the Subcommittee. My name is Allen J. Fishbein and I am the General Counsel of the Center for Community Change and director of its Neighborhood Revitalization Project. I welcome this opportunity to present the views of my organization on reform of the financial system.

The Center for Community Change is a national non-profit organization, based here in Washington, DC, that provides advice and technical assistance to a broad variety of community-based organizations representing the residents of low and moderate income and predominately minority communities. Much of our work with these grass roots organizations involves helping these groups to assess community credit needs, evaluate the performance of lending institutions in meeting these needs, document discriminatory and otherwise unfair credit practices and develop neighborhood-based reinvestment strategies designed to increase the lending by financial institutions in lower income communities. We also monitor the performance of the federal banking regulatory agencies in enforcing laws, such as the Community Reinvestment, Home Mortgage Disclosure, and Fair Housing Acts.

In this current series of hearings, the Subcommittee is considering a number of financial services restructuring proposals that would dramatically expand traditional banking powers as well as the way in which financial services are delivered to the public. Most of the attention thus far has centered on extending bank entry into the securities business. Other proposals have recommended that banks be permitted to underwrite and sell insurance and real estate. All of these restructuring proposals raise important public policy concerns, the most important of which center around whether the walls between banks and their non-banking affiliates will be strong enough to withstand the financial shocks that will inevitably occur as these institutions engage in inherently riskier and more volatile activities. And indeed, these concerns are certainly worthy of careful deliberation by the Subcommittee.

However, another area of inquiry that the Subcommittee should consider in weighing the need for reform of the financial system is how well the traditional system of banking is serving the credit and deposit services needs of local communities and what impact, if any, expanded powers will have on the ability of banks to continue to serve their traditional customer base. My testimony will focus on these issues:

There are four major points I want to make here today: 1) There are significant credit access and deposit services gaps that are not being adequately met by banks; 2) The laxness of enforcement by the federal banking regulators of existing consumer and community reinvestment requirements has contributed to these market failures; 3) Expanded powers, in and of themselves, will not address these consumer and community needs; 4) Congress should couple financial services restructuring legislation to explicit measures to improve the performance of banks in serving low and moderate income communities.

To begin with, let me discuss the existing problems that are being encountered by the residents of older urban neighborhoods and slow growth areas. Adequate investment by banks and other depository lenders is critical to the preservation and revitalization of local economies. At the same time, the rapid transformation in the financial services industry brought about by deregulation and technological innovation raise concerns for many communities about the continuing availability and affordability of home mortgages, small business loans, checking accounts and other banking services.

Over the past decade or more a considerable body of research has been developed which suggests that banks and other depository lenders have disinvested certain segments of their service areas and otherwise shunned important needs of local economies. Evidence of redlining and other discriminatory lending practices led Congress to adopt corrective measures such as the Home Mortgage Disclosure and Community Reinvestment Acts. Yet, more recent research indicates that credit availability problems continue to exist mostly in inner-city and other low and moderate income neighborhoods. Moreover, several recent studies point to race as continuing to be a significant factor in the distribution of mortgage credit in metropolitan areas, a decade after passage of the Fair Housing Act.

While most of the research has focused on housing related lending since data on the geographic location of this type of bank lending is available as a result of the Home Mortgage Disclosure Act, a recent study suggests that similar disparities in lending patterns may exist for commercial and industrial lending. The study, released by the Woodstock Institute, a Chicago-based non-profit research organization examined commercial lending information made available as a result of the requirements of that city's local depository law. The study found that Chicago banks made twice as many commercial loans to suburban businesses as to city businesses. Moreover, the researchers found that seventy percent of all of the commercial lending within the city occurred to businesses located in the downtown area. In other words, only a tiny fraction of commercial lending by local banks was made to businesses located in Chicago's neighborhoods.

Continuing credit access and deposit services problems are also responsible for the record number of CRA challenges by community groups to bank mergers and other applications that have already occurred this year. The federal banking regulators report that more than forty CRA challenges have been filed in the first eleven months of this year. This represents an increase in CRA challenges over 1986 and a continuing increase over the past three years. In fact, the Federal Reserve Board, which regulates bank holding companies and state-chartered members banks processed as many CRA challenges in the past two years as it had the previous eight years that law was in effect.

At the same time, deregulation and the increasing fees and service charges it has meant for depositors appears to be pricing small savers and low-income consumers out of the banking system. The clearest evidence of this trend is data from the Federal Reserve Board's periodic survey of household finances. Between 1977 and 1983, according to this research, the proportion of lower and lower middle income families with current accounts declined. Yet the need of these families for such services as check cashing and funds transfer still exists. These services are increasingly being provided by check-cashing outlets and liquor stores that charged higher prices than banks, exposed consumers to greater risks, and effectively denied them the savings option.

The second point I would like to emphasize is that lax enforcement of CRA and the fair lending laws by the federal regulatory agencies is contributing to the types of problems that I described above. Community groups are openly critical of the manner in which the federal regulators have handled CRA protests. The regulators routinely deny requests for public hearings or even extensions of the public comment period. They often fail to consider relevant evidentiary material produced by CRA protestants. The regulators have not denied a pending bank application on CRA grounds in the last eight years.

In addition, the CRA examination process which was intended to be an integral part of enforcement of the Act has been given low priority by all the regulators, with the possible exception of the Federal Reserve Board. Under the examination process, institutions must be examined on a periodic basis and are supposed to be rated on their CRA performance, on a scale of 1 to 5, with "1" being the highest rating and a "5" rating the lowest. According to the aggregate rating data that is compiled by the agencies on an annual basis very few (less than five percent) of the institutions examined received a less than satisfactory or poor rating. For example, in 1984, only one out of the nation's 245 largest banks examined received an unfavorable CRA rating from the regulators. This widespread rating inflation has produced a disincentive for lenders to continue to improve their lending performance and address the problems discussed earlier in my testimony.

Thirdly, we believe that financial services restructuring that would permit expanded powers would do little to meet the basic consumer and community needs that I have described. Proponents of expanded banking powers maintain that allowing banks or their affiliates into these new fields will promote competition, which in turn should lower costs for the consumers of these specialized services. Even assuming that these predictions are correct, the benefits generated by bank entry into these new fields will accrue to the users of these services, such as affluent customers who wish to invest in the stock market or mutual money market funds. Expanded powers will provide few direct benefits to most consumers, and certainly not low-income consumers and communities.

At the same time, it is conceivable that financial services restructuring could lead banks to devote more and more of their resources to upscale customers who are expected to be primary users of expanded financial services products and thus, further intensifying the demarketing strategies to low income areas that has been associated with the earlier phases of banking deregulation. Moreover, we reject the notion, as some have argued, that expanded powers will increase bank profitability and automatically lead them to do a better job at serving the lower end of their traditional market. That form of trickle down economics is unlikely to occur in the absence of strong and explicit statutory mandates for improved services to the low income consumers.

Finally, we believe Congress must take strong action to improve access to banking services in low and moderate income communities, as well as seek improvements in the quality and terms of services for all consumers. If Congress should decide to proceed with restructuring of the financial services industry it should do so in a balanced manner, one which seeks to minimize the adverse effects of expanded powers. Consequently, we believe that financial restructuring must be tied to explicit guarantees designed to assure improvements in the delivery of traditional banking services. Banks seeking to exercise new power should be required to exercise expanded responsibilities to serve their existing customer base as well. Further, we believe that the moratorium on expanded banking powers should be extended until such time as a comprehensive financial restructuring proposal is enacted by the Congress. Allowing the piecemeal dismantlement of existing prohibitions against banking and commerce by the federal regulators would not provide the consumer and community reinvestment protection we believe are necessary.

Recommendations

The Subcommittee should consider a three-part strategy for addressing the access problems that I described in my testimony. First, take steps to improve enforcement of existing consumer and community reinvestment laws. Second, limit expanded powers to those banks with an outstanding record in complying with existing consumer and community reinvestment requirements. Third, tie expanded privileges to expanded responsibilities.

1. Several immediate steps could be taken to improve enforcement of the existing community reinvestment, fair-lending, and consumer protection laws.

   - The Subcommittee should conduct tough oversight hearings to determine how well the federal regulators are performing in enforcing these requirements. Similar hearings are already planned by the Senate Banking Committee.

- The regulators should be required to disclose to the public a summary of the CRA performance for each bank they have examined.
- Legislation should be adopted requiring banks and other financial institutions to disclose the geographic location of their commercial and industrial lending. The public disclosure of this information would provide citizens and small business persons with access to information about how well banks and other financial institutions are serving the credit needs of their communities. Information about commercial lending should be made available to the public in a format comparable to the information currently disclosed by depository lenders under the Home Mortgage Disclosure Act.

Additionally, financial restructuring will introduce new regulatory considerations for the federal bank regulators which may require significant increases in resources. At the same time, we know that the regulators are not fully meeting their responsibilities in ensuring bank compliance with existing community reinvestment and consumer protection laws. Therefore, before the agencies are required to take on new responsibilities entailed by financial restructuring, they should be required to develop a scheme for improving their enforcement of existing law, either through the creation of separate consumer compliance examinations, as is now conducted by the Federal Reserve Board, or by delegating that function to another independent agency, such as the Federal Trade Commission.

2. The entry by banks into new fields should be limited to only those banks with superior CRA records. This requirement, establishing CRA as a "toll gate" for banks exercising new powers would necessitate an expansion of the existing law to include applications to acquire non-depository affiliates. Moreover, since the existing rating system is not a reliable indicator of bank performance in meeting their CRA obligations, the Subcommittee should consider a mechanism to limit the number of institutions seeking permission to engage in expanded powers to only those banks with truly superior CRA records. For example, an upper limit on the percentage of banks that can receive an excellent, or "1" rating at any given time. A percentage limit would foster competition among banks to improve their CRA performance or risk losing their eligibility for expanded powers.

3. Bank entry into new fields should be viewed as a privilege. Accordingly, banks seeking to utilize new power should have additional community reinvestment and consumer requirements imposed on them as well. The applicability of this quid pro quo policy to granting banks new privileges was recognized by the full Committee in 1985 when it adopted the Oakar-Schumer Community Benefits Test amendment as part of the Committee's passage of interstate banking legislation. The Oakar-Schumer Amendment required more stringent public disclosure requirements and

community reinvestment standards for bank holding companies seeking to acquire other institutions across state lines than were required for the banking industry in general. This approach should be applied to banks seeking entry into investment banking, or insurance, or real estate. For example, banks seeking entry into new fields would by required to offer and market low-cost checking and saving accounts, as well as cash government checks even for non-account holders. Similarly, banks seeking to underwrite and deal in securities would have an affirmative responsibility to set aside a portion of their new powers, for products that would be expected to benefit low-income people. In other words, a bank seeking to underwrite mortgage-backed securities would be required to set aside a percentage of its activity to underwrite mortgage backed-securities for low-income rental housing.

It is worth noting that an application of the quid-pro-quo approach to expanded powers was pioneered by New York State. In 1984, the state permitted state-chartered banks to invest in real estate development, but wrote regulations that tied this new authority to a requirement that these same institutions expand their investment in low and moderate income communities. For each dollar invested in real estate, the regulations required banks to set aside at five cents for development in targeted neighborhoods and to specially designed types of projects. We strongly urge the Subcommittee to adopt this approach should it decide to act on the various financial restructuring proposals.

This concludes my formal testimony. I would be glad to respond to any questions.

TESTIMONY OF JONATHAN BROWN
DIRECTOR, BANKWATCH
BEFORE THE
COMMITTEE ON BANKING, FINANCE & URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
December 2, 1987

Mr. Chairman and members of the Committee. I appreciate the opportunity to present BankWatch's views on the fundamental issue of financial restructuring.

The ultimate question before the Committee is whether to authorize or continue to prohibit integration within the financial service industry -- the combination of banking, securities, insurance, and real estate development activities within diversified financial service firms. This complex decision will require a judicious weighing of the potential benefits of integration against the potential adverse effects along a number of dimensions. These dimensions are best examined from the perspective of bank entry into other financial service sectors, in view of banks' dominant position in the financial industry, the existence of the federal safety net for banks, and banks' key role as commercial lenders and a backstop source of liquidity.

Enhanced Competition and Efficiency

How much public benefit in the form of additional competition and greater efficiency is likely to result from bank entry into various new financial service activities? Will bank entry result in a net increase in the number of competitors in specific product or geographic markets? Can banks' branch networks and financial skills be used more efficiently if banks are allowed to offer additional financial services?

BankWatch's preliminary conclusion is that bank entry could introduce significant new competition into the underwriting of small issue or innovative securities, such as debt instruments for medium size businesses, securitized pools of small business, commercial mortgage, or multi-family housing loans, and municipal revenue bonds of smaller political jurisdictions. However, the issuers of such securities are to a large extent the customers of small and medium-sized banks, not the large banks who are pushing for securities powers, and a serious question exists as to whether small and medium-sized banks have the expertise to properly execute sophisticated securities transactions.

Bank authority to underwrite the securities of large corporations or large political jurisdictions would be likely to provide only modest gains in enhanced competition. While these markets are at present quite concentrated, large issuers have considerable market power themselves, which should tend to offset the oligopoly power of the securities underwrites.

Bank brokerage of securities and insurance products through their branch systems could result in significant economies of scope. However, in regard to insurance brokerage these potential operating efficiencies are not likely to be passed along to consumers because of the lack of competitive pressure from the demand side, i.e., the failure of consumers to fully understand and comparison shop for insurance products. For consumers to benefit from bank entry into insurance brokerage will require the establishment of new mechanisms to provide consumers with comparative price and educational information on insurance products. In addition, the state level anti-rebate laws, which preclude price competition between insurance brokers, must be overridden by federal law.

Bank Safety and Soundness

In BankWatch's view, with one exception, the risks that expanded financial service powers for banks pose to the federal safety net for banks can be contained within acceptable bounds by a strong system of prudential safeguards. Such a system would include the lodging of new activities involving financial risk or significant funding requirements in separate subsidiaries of a bank holding company, strict prohibition of transactions between banks and their expanded powers affiliates, and vigorous regulation of expanded powers affiliates themselves. The single exception to this general conclusion is the exercise of real estate equity powers. Bank investments in real estate equity are so inherently risky that they should not be authorized or, if authorized, should be limited to a very small fraction of a bank's capital.

Although some securities and insurance activities are riskier than banking, these risks can be brought within acceptable levels by prudential safeguards. More importantly, securities and insurance activities are already regulated in their own right, so this would not involve bank entry into unregulated markets. Yet, there is clearly a need to strengthen prudential regulation of securities and insurance before we should rely on regulation by function as an alternative to Federal Reserve Board regulation under the Bank Holding Company Act.

One must recognize, however, that there is a serious conflict between the goal of greater efficiency via economies of scope and the goal of risk containment via separate subsidiaries and restriction of transactions with affiliates. To what extent effective prudential safeguards would preclude the potential benefits of greater efficiency is an issue that this Committee should explore in depth.

Additionally, given BankWatch's basic concern with promoting corporate accountability, we have strong reservations about endorsing the concept of separate subsidiaries, even though the concept of corporate separateness is a useful prudential device. From our vantage, it is no more appropriate to insulate a large bank holding company or bank from liability for irresponsible conduct by a securities, insurance, or real estate affiliate than it is to permit Exxon to avoid liability for oil spills by placing its tanker fleet in a thinly capitalized separate subsidiary.

Conflicts of Interest

Bank involvement in underwriting, retail distribution, dealing, and full service brokerage of corporate equity and debt securities poses serious conflicts of interest. These conflicts arise because banks have potentially competing interests as lender to corporations and also access to insider information as lenders. The potential for abuse is particularly great in regard to mutual funds and other pooled investment vehicles that include corporate debt and equities, since it is less obtrusive to hide bad securities in a larger pool than to distribute them solo.

As demonstrated by the actions of bank securities affiliates during the 1920's, these conflicting interests can result in serious distortions in the capital market, biased investment advice, and the shifting of likely losses on unsound investments from banks to the public. Interestingly, these injuries occur primarily to the capital market and individual investors, not to bank safety and soundness. Thus, the spate of recent literature arguing that bank securities activities of the 1920's did not in fact damage bank safety misses the real point.

The only clean solution to the problem of such conflicts of interest would be to prohibit banks from becoming involved with any security in which they have a preexisting interest as creditor. Yet, this could significantly undercut the potential economies of scope that stem from bank knowledge of the financial needs of individual borrowers. Another option would be to establish stronger securities laws to cover these conflict situations. Yet, it is questionable whether the federal banking regulators would enforce such safeguards with any vigor, given the major supervisory burden involved and the fact that violations of such safeguards would only injure the general public, not bank safety and soundness. The Committee should research these issues thoroughly.

By way of contrast, the conflicts inherent in bank securities activities involving municipal revenue bonds and mortgage backed securities that conform to established underwriting standards are substantially less than those involved with corporate debt and equities. Adequate safeguards would appear to be feasible in these areas.

Anti-competitive Tying

When banks have leverage over borrowers, they are in a position to tie insurance or securities products to credit access. Such coercive tying, whether explicit or implicit, foreclose competition and could negate any competitive benefits from bank entry or even reduce the level of competition in the market for the tied product.

In BankWatch's view, strong anti-tying safeguards should be able to contain the problem of tying in regard to bank marketing of insurance products to consumers. However, such safeguards should be as self-executing as possible -- for example, prohibiting insurance sales while a loan application is pending. We entertain considerable skepticism as to willingness of bank regulators to commit scarce supervisory resources to enforcement of more subtle anti-tying safeguards.

By way of contrast, we doubt that anti-tying safeguards would be effective in preventing the tying of insurance products to small business credit. Banks have such inherent credit leverage over small business borrowers that many such borrowers would most likely view it in their long term interest as borrowers to place their insurance business with their bank.

The securities industry has presented data which suggest that banks may have used their credit leverage to capture manager positions in the underwriting of municipal revenue bonds that fall within the limited categories of revenue bonds that are currently eligible for bank underwriting. The potential for tying would seem to be particularly significant in regard to underwriting municipal revenue bonds that require credit enhancement, such as mortgage revenue bonds with put options. The Committee should investigate this issue thoroughly before granting banks general authority to underwrite municipal revenue bonds.

Structural Concerns Posed By Consolidation of the Banking, Securities, and Insurance Sectors

Beyond the potential benefit/potential adverse effect calculus for individual financial products, the Committee should also explore the broader implications of merging the separate banking, securities, and insurance sectors into a unified financial service industry. While significant overlaps currently exist between the different sectors, they still operate as separate decision making centers.

Prohibiting mergers between the largest banks, securities firms, and insurance firms would undoubtedly slow down the process of consolidation into a single financial service sector. Yet, even with such a prohibition, in the long run the emergence of giant financial conglomerates -- combining at least banking, securities, and investment management, if not insurance -- is likely to result in unification.

Giant financial conglomerates will have more leverage over industrial, commercial ,and agricultural corporations than giant, but separate, banks, securities, and insurance firms. One of the real advantages of the growth of separate financial sectors in the United States over the last 70 years is that it inhibited the financial sector control over real sector corporations that was manifest in the heyday of the Money Trusts at the turn of the century. Today there is a broad consensus that financial firms should be the servants of corporations in the real sectors of the economy, not their masters.

Moreover, given banks' dominant position among financial institutions in terms of assets and capital, their access to the federal safety net, and their unique role in supplying liquidity, they are likely to emerge as the controlling power in most major financial conglomerates. This would result in parallel rather than competing strategic interests among the larger financial conglomerates. Such a situation would most likely enable the larger financial conglomerates to follow a common strategy of promoting more expensive bank products, such as commercial loans, and deemphasizing less expensive securities alternatives, such as commercial paper. This pattern is certainly in evidence in West Germany where banks control the securities industry and German industrial corporations are heavily dependent on bank credit, while the growth of corporate debt and equity securities has been stunted.

Finally, a financial system comprised of separate sectors provides an important set of checks and balances that are missing in a consolidated financial system. For example, a separate securities sector provides a better check on the quality of bank loans that are being securitized than a securities industry dominated by banks. Similarly, locating mortgage insurance firms and other credit insurance activities within an independent insurance sector provides a stronger brake against deterioration of credit standards than allowing financial conglomerates dominated by banks to perform the credit insurance function. While efforts can be made to curb such conflicts of interest within financial conglomerates, the lack of separate financial sectors will inhibit the development of independent standards that are so essential as a frame of reference. Hence, unification is likely to result in greater instability in credit standards and amplify the boom-bust cycles that traditionally plague different types of credit.

Unification of the financial service industry has contradictory implications. It may enhance efficiency and innovation in the delivery of financial services at the individual firm level, but the financial system as a whole may do a poorer job in servicing the real economy due to an augmentation of financial power and greater financial instability. The Committee might well ponder an analogy between the separation of sectors within the financial industry and separation of powers under the United States constitution. Our constitution does not provide us with the most efficient decision making process, but what nation has designed a better structure for political stability?

Recommendation

Proper review of the potential benefit/potential adverse effect calculus for specific financial services will require considerable investigation on the part of the Committee. An adequate exploration of the underlying implications of unification of the separate financial sectors will require an even broader investigation.

BankWatch recommends that the Committee quickly adopt legislation that would set in motion a two year investigation of these issues under the direction of the House and Senate Banking Committees. Such legislation should identify specific issues that would be investigated. Where appropriate, the legislation should also identify specific information which can be most effectively collected by the various federal regulatory agencies and direct the agencies to collect such information.

Finally, BankWatch recommends that such legislation extend the moratorium on expanded powers established by the Competitive Equality Banking Act of 1987 for duration of the proposed two year study period. Failure to restrain free lance deregulation initiatives by the federal banking regulators and individual states during this review period would undermine the Congress's ability to shape the nation's financial structure and render the Banking Committees' investigations purely academic.

Testimony Presented by
Mildred Brown, President of ACORN
to the
Subcommittee on Financial Institutions Supervision,
Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
December 2, 1987

Good morning, Chairman St. Germain, Members of the Committee and other Members of Congress. I am Mildred Brown, President of ACORN's National Association Board. We are glad that you have decided to draw on ACORN's views and experience in shaping policy for restructuring the financial services industry.

ACORN, The Association of Community Organizations for Reform Now, is the largest grassroots membership organization of low and moderate income people in the country. Over the past 17 years, ACORN has grown to include 70,000 member families, in hundreds of neighborhood groups, in 40 cities, in 29 states.

ACORN is fighting for access to banking services. Using the Community Reinvestment Act, (CRA), ACORN groups around the country have gotten banks to commit to invest over $400 million in low income neighborhoods. These agreements contain many other key provisions, including commitments to develop and market affordable checking and savings accounts; use alternative creditworthiness standards in evaluating loan applications; count sweat equity as part of the downpayment on a property; provide and pay for loan counseling and packaging; and put branch offices in our neighborhoods.

ACORN members are aware that banks and S&Ls can tip the scales between success and failure in our work to stabilize and revitalize our neighborhoods. When banks becomes willing partners in our projects to reclaim housing and promote economic development we have made real progress towards our goals. But most low income neighborhoods remain credit starved, and hundreds of thousands of poor people go without banking services of any kind.

My hometown, Philadelphia, offers examples of some of the best and worst in bank performance. On the negative side, the acquisition of Girard Bank by Mellon Bank Corp. was followed by branch closings which left as many as 15 census tracts of North Philadelphia without a banking facility.

In contrast, in 1985, Fidelcorp committed to make over $72 million in loans in Northcentral Philadelphia. By the end of October 1987 Fidelity Bank had taken in 2831 applications for housing rehab and home improvement loans, and 1702 had been approved. By the end of October Fidelity had loaned out $3,321,175 and had $5,615, 635 in outstanding loan commitments.

Philadelphia ACORN hammered out an agreement with Continental Bank to invest more than $40 million in our neighborhoods. Among other commitments, Continental pledged to send personnel out to our neighborhoods to oversee that sufficient loans are going to low income people.

ACORN has developed a fine working relationship with both of these banks -- senior officers have appeared in forums around the country to challenge other bank officials on their stereotypes about low income and minority borrowers. Our friends at Fidelity and Continental now often sound like ACORN members.

But ACORN's relationship with Fidelity and Continental began with months of hard and often bitter negotiations. I was a member of the negotiating team for both challenges and I recall the exhaustion of staying in sessions with Fidelity until 2:00 am, and of full-day Saturday meetings with Continental.

The CRA process requires that community groups move mountains. The people that banks have historically ignored and redlined must take a crash course in banking in a couple of weeks and dig up enough evidence of a bank's negligence to trap the attention of a regulator. And from where ACORN members sit, most regulators look and sound just like bankers. It is hard to believe that regulators are paid to protect our interests.

With these experience behind us, ACORN is worried about the grab by banks for expanded powers. **Most banks have not come close to living up to their current legal responsibilities to serve low and moderate income people.**

Banks want Congress' permission to sell and underwrite securities, insurance and real estate. But even if the bankers' most hopeful predictions come true -- even if these expanded powers promote competition and lower the costs of financial services to consumers -- this will provide no direct benefit to low income people. Unless Congress takes the necessary precautions, banks will use more and more of their resources and skills to serve the types of customers who can afford to buy stocks and real estate. The people that banks are already neglecting will receive even less attention.

To prevent such a disaster, ACORN calls upon Congress to make the moratorium on expanded powers permanent. Banks are not meeting their basic legal duties and must therefore not be granted new privileges.

We know that intense pressure is being put on Congress to grant new powers to banks. If Congress eventually approves expanded powers, it is essential that at the same time Congress require banks to give something significant to the community in exchange. As a minimum,

--All banks and S&L's should be required to offer and aggressively market low cost checking and savings accounts, and to cash government checks for people without accounts, charging no more than their costs.

--All banks and S&Ls should be required to regularly report on the loans they make to businesses. Where are these institutions making their commercial loans? We must be able to find out whether small and minority owned businesses are being given access to credit. This information about commercial loans should be made available to the public in the same way that banks now disclose their home mortgage and home improvement loan activity.

-- The Community Reinvestment Act should be expanded to permit community groups to challenge applications by banks for new powers. CRA is our main tool to keep banks accountable to the low income people in their service areas. CRA isn't perfect: it places a heavy burden on community groups to prove that a bank comes up short, and leaves regulators free to ignore the evidence we collect. But CRA challenges are our chance to fight back against the redlining that clogs the flow of credit to our neighborhoods. We must be able to use CRA to try to stop irresponsible banks from transforming themselves into new, more powerful types of institutions.

-- The regulators tell us that they don't have the resources to thoroughly and frequently examine banks for compliance with CRA, the Fair Housing Act and the Equal Credit Opportunity Act. It seems to us that alot of money gets spent at the agencies on pomp and frills and public relations. But if the money to do tough exams really isn't there, the regulators should be given earmarked funds. Why not charge those banks that want expanded powers a fee to pay for thorough, honest CRA exams? And regulators should be required to go out and look at neighborhoods and talk to community groups as part of every exam.

Also, since regulators are not able to enforce current law they should not be handed additional responsibilities by Congress. That is, until the regulators show that they can adequately enforce CRA and related laws they should not be asked to take on the added burden of supervising banks' use of new powers.

-- Everyone in the community has a right to know whether banks are obeying the law. The regulators must publish their summary assessments of CRA exams. We hear that the ratings that banks get are wildly inflated, and that big banks, especially, hardly ever get low scores. We also hear that no more than a few paragraphs in exam reports are devoted to CRA. We need to see this for ourselves. Grassroots bank examiners like ACORN members want to compare our assessments of banks with those of the regulators, and in this way, encourage the regulators to go all out to find the truth about bank performance.

If banks get expanded powers, we expect them to ignore their responsibilities to low income people -- unless their feet are held to the fire by the regulators under orders from Congress.

-- Only those banks with the very best CRA records should be permitted the privilege of entering into new lines of business. To make this requirement meaningful, the CRA rating system must be reformed to stop raging grade inflation. One suggestion is to set an upper limit on the percentage of banks that can receive scores of 'good' or 'excellent'. However it is done, Congress must make sure that a bank is in total compliance with current law before granting a bank the reward of new powers.

-- Last, and perhaps most importantly, the Committee should create ways to guarantee that giving banks new powers will directly ease the credit crunch in low income communities. Along with new powers, banks should be given affirmative responsibilities to set aside some portion of the new activity to benefit low income people. If, for example, a bank chooses to underwrite mortgage backed securities some percentage of these mortgages should originate in low income neighborhoods. Bank should also be required to work together to create secondary markets to buy loans made to nonprofit developers working in low income neighborhoods. ACORN hopes to be part of an intensive conversation about these affirmative responsibilities with the Committee and other interested parties during the next months.

And in the meantime, while the Committee is considering the policy implications of expanded bank powers, we urge you to hold searching oversight hearings on enforcement of the Community Reinvestment Act. ACORN and other community groups should be called to testify at these hearings along with the heads of the regulatory agencies. We look forward to helping the Committee in structure these hearings.

Thank you for your close attention to our proposals.

Appendix III-B-10

Large U.S. Securities Firms Ranked by Amount of Capital, 1979-86[1]

	Year and Rank							
Name	1986	1985	1984	1983	1982	1981	1980	1979
Dean Witter Financial Services Inc./ Dean Witter Reynolds Organization Inc.		4	4	4			5	
Drexel Burnham Lambert Incorporated	5							
The E. F. Hutton Group Inc.			5	5	4	3	3	4
Goldman, Sachs & Co.	4				5	5		
Merrill Lynch & Co., Inc.	3	1	1	1	1	1	1	1
Paine Webber Incorporated								3
Prudential Bache Securities Inc.		5						
Shearson Lehman Brothers Inc./ American Express Inc./Loeb Rhoades Inc.	2	2	2	3	3	4	2	2
Salomon Brothers Inc.	1	3	3	2	2	2	4	5

	1979	
	Capital	Ran
Merrill Lynch & Co.	$ 784,245,000	1
Shearson Loeb Rhoades Inc.	246,254,559	2
Paine Webber Incorporated	243,200,000	3
The E.F. Hutton Group Inc.	237,954,000	4
Salomon Brothers Inc.	228,700,000	5

	1980	
	Capital	Ran
Merrill Lynch & Co.	$ 969,481,000	1
Shearson Loeb Rhoades Inc.	469,883,000	2
The E.F. Hutton Group Inc.	448,037,000	3
Salomon Brothers	330,700,000	4
Dean Witter Reynolds Organization Inc.	274,067,000	5

	1981	
	Capital	Ran
Merrill Lynch & Co.	$1,263,907,000	
Salomon Brothers Inc.	719,100,000	
The E.F. Hutton Group Inc.	534,492,000	
Shearson/American Express Inc.	526,982,000	
Goldman, Sachs & Co.	389,000,000	

	1982	
	Capital	Ra
Merrill Lynch & Co.	$1,685,277,000	
Salomon Brothers Inc.	1,051,124,000	
Shearson/American Express Inc.	836,615,000	
The E.F. Hutton Group Inc.	608,061,000	
Goldman, Sachs & Co.	478,000,000	

	1983	
	Capital	Ra
Merrill Lynch & Co.	$2,023,731,000	
Salomon Brothers Inc.	1,268,693,000	
Shearson/American Express Inc.	1,056,555,000	
Dean Witter Financial Services Inc.	964,656,000	
The E.F. Hutton Group Inc.	746,480,000	

Page 3

	1984	
	Capital	Rank
Merrill Lynch & Co., Inc.	$2,214,574,000	1
Shearson Lehman Brothers Inc.	1,896,000,000	2
Salomon Brothers Inc.	1,576,800,000	3
Dean Witter Financial Services Inc.	1,237,045,000	4
The E.F. Hutton Group Inc.	1,019,886,000	5

	1985	
	Capital	Rank
Merrill Lynch & Co., Inc.	$2,646,880,000	1
Salomon Brothers Inc.	2,320,097,000	3
Shearson Lehman Brothers Inc.	2,251,000,000	2
Dean Witter Financial Services Inc.	1,365,331,000	4
Prudential Bache Securities Inc.	1,259,260,000	5

	1986	
	Capital	Rank
Salomon Brothers Inc.	$3,209,205,000	1
Shearson Lehman Brothers Inc.	3,122,148,000	2
Merrill Lynch & Co., Inc.	2,864,779,000	3
Goldman, Sachs & Co.	1,951,000,000	4
Drexel Burnham Lambert Incorporated	1,846,381,000	5

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1/ Securities Industry Association Yearbooks 1979-1986.

APPENDIX IV-B-1

APPENDIX I

RESEARCH MEMORANDUM CONCERNING TIE-INS OF BANK CREDIT FACILITIES TO SELECTION AS MANAGING UNDERWRITER OF MUNICIPAL HOUSING REVENUE BOND ISSUES

The attached tables illustrate the involvement of three major commercial banks in letter of credit put bond transactions. In such transactions a major bank provides a letter of credit to enable an issuer to sell a 20-year plus bond which a bond holder can tender back to the agency at par at the end of, say, five years and annually thereafter. Such a right to "put" a bond early lowers the interest rate on the bond substantially. Only large commercial banks have the financial strength to bear the enormous risk of such a repurchase obligation. These charts are based on data derived from the Bond Buyer and Official Statements relating to the particular bond issues. The transactions are single family and multi-family housing revenue bond offerings. These issues were selected because housing bonds are excepted from the general Glass-Steagall prohibition against commercial bank underwriting and, unlike general obligation bonds, most often involve negotiated underwritings rather than underwritings through public bids.

It has been suggested that commercial banks have used their ability to provide necessary credit facilities as leverage to obtain managing underwriter positions. Although eligible to underwrite housing revenue bonds since 1968, banks have had modest success in becoming managing underwriters until of late.

The data shows a remarkable coincidence of banks supplying letters of credit for put bonds and for security and participation in the managing underwriter group. There were approximately half as many housing bond issues in 1981 as in 1980 (primarily as a result of new Congressional restrictions and market conditions). However, as Table 7 indicates, Citibank was able to participate as a managing underwriter in even more negotiated housing offerings in 1981 than in 1980. Crocker, which did not participate as a manager in any negotiated housing issues in 1980, was a managing underwriter in six in 1981. Manufacturers Hanover also did not participate as a manager in any negotiated housing bond underwritings in 1980 yet participated as a manager in two such offerings in 1981.

In every single negotiated housing bond offering involving a letter of credit supplied by Citibank, Crocker or Manufacturers Hanover, the bank was in the management group--24 times out of 24. It appears as if none of the banks was a manager in a housing bond issue in 1981 where it did not supply a credit facility.

These statistics are testimony to a dramatic entry into negotiated underwritings of housing bonds as a result of the financial capacity to provide credit facilities. In addition, in every one of the 24 situations the banks obtained the right to invest all proceeds of the bond issues and related funds for the life of the bond issues. Table II provides the details of the 24 transactions which have been identified.

Typically, the banks involved in these transactions receive the following as compensation:

1. Fees paid to managing underwriters and a manager's participation in the underwriting;

2. Annual fees (typically, 45 basis points at closing and 90 basis points per year);

3. The spread between rates paid under the investment contract and the bank's investment yields; and

4. A termination fee (payable from monies left at the conclusion of the program in an amount sufficient to increase each annual fee to 112 basis points).

The value of these various income sources is, of course, dependent on many factors. These include interest rates over the life of the program (which would impact on the value of the investment contract and availability of money to pay the termination fee) and the number of mortgage loan prepayments experienced by the issuer (which would affect the amount of outstanding bonds against which the annual fee percentage is applied).

For example in a State of New York Mortgage Agency $100,000,000 bond issue ($96,650,000 of which were put bonds) the "break even" tax exempt rate (*i.e.*, the market rate for one-year, tax-exempt debt at which the bank's loss on resale of bonds "put" back to it exceeds its profit from the transaction) was 18%. When the tax-exempt rate for one-year paper is less than 18% the bank makes money, when greater than 18%, the bank loses money. (At no point in history has one-year tax-exempt paper approached a rate anywhere near as high as 18%.) In this transaction the before-tax value of the components of income *other than* the management fee, assuming a constant 13% tax-exempt rate and 100% FHA prepayment experience, was $23,840,000. Using the same tax-exempt rate, but assuming no prepayments, the payment to the bank would be in excess or $50,500,000. Actual prepayment value of the experience would probably fall between 100% of FHA experience (the assumption required by Section 103A of the Internal Revenue Code, as amended) and no prepayments. Therefore, the range for the fee, exclusive of the share of the underwriting management fee, was between $23,840,000 and $50,500,000.

TABLE I

1980-1981 Comparison of Commercial
Bank Involvement in Housing Issues

		1980		1981
Total Housing Issues		484 ($14,267,101,944)		239 (7,045,452,00
Total CITIBANK				
Negotiated bond underwritings in which it was a member of management group		14		16
Total credit facilities supplied in underwritings in which it was a member of management group		7		16
Put Bonds	3		15	
Security Letters of Credit	4		1	
Total CROCKER NATIONAL BANK				
Negotiated underwritings in which it was a member of management group		0		6
Total Credit facilities supplied in underwriting in which it was a member of management group		0		6
Put Bonds	0		5	
Security Letters of Credit	0		1	
Total MANUFACTURERS HANOVER TRUST CO. in which it was a member of management group		0		2
Total credit facilities supplied in underwritings in which it was a member of management group		0		2
Put Bonds	0		2	
Security Letters of Credit	0		0	

TABLE II

SCHEDULE OF PUT BOND DEALS

CITIBANK PUT BOND DEALS

ISSUE	MEMBER OF MANAGEMENT GROUP	PUT BOND FEATURE	INVESTMENT AGREEMENT
1. $50,000,000 City of Baltimore, July 1, 1981	x^a	x^1	x^2
2. $23,205,000 Barton Co., Kansas, April 1, 1981	x^a	x^1	x^2
3. $150,000,000 Brevard Co. Housing Finance Authority, February 1, 1981	x^c	x^1	x^2
4. $43,915,000 Denton Co. Housing Finance Corp., November 1, 1980	x^b	x^1	x^2
5. $18,845,000 Hutchinson, Kansas, April 1, 1981	x^b	x^1	x^2
6. $64,715,000 Johnson Co., Kansas, April 1, 1981	x^b	x^1	x^2
7. $200,000,000 Louisiana Public Facilities Authority, April 1, 1981	x^b	x^1	x^2
8. $104,750,000 State of New York Mortgage Agency, November 1, 1981	x^b	x^1 x^2	

ISSUE	MEMBER OF MANAGEMENT GROUP	PUT BOND FEATURE	INVESTMENT AGREEMENT
9. $130,000,000 Orange Co., Fla. Finance Authority, May 1, 1981	x^a	x^1	x^2
10. $118,500,000 Pomona, CA. Redevelopment Agency, April 1, 1981	x^c	x^1	x^2
11. $105,000,000 Pueblo Co., Colo., March 1, 1981	x^b	x^4	x^2
12. $24,800,000 Residential Housing Facilities Board of Pulaski Co., Arkansas, December 1, 1980	x^b	x^3	x^2
13. $25,000,000 Shawnee Co., Kansas, June 1, 1981	x^b	x^1	x^3
14. $23,305,000 Tom Green Co. Housing Finance Corp., November 1, 1980	x^a	$x^{4,5}$	x^2
15. $24,595,000 Williamson Co., Tex. Housing Development Corp. December 1, 1980	x^b	x^3	x^3
CROCKER NATIONAL BANK PUT BOND DEALS			
16. $100,000,000 Alaska Housing Finance Corp., December 1, 1981 $75,000,000 Option Bonds	x^b	x^6	x^2
17. $35,000,000 Leavenworth Co., Kansas, November 1, 1981	x^a	$x^{1,7}$	x^3
18. $47,410,000 Massachusetts Housing Finance Agency December 1, 1981 $40,000,000 Option Bonds	x^b	x^8	x^2
19. $20,185,000 City of Roswell, N.M., September 1, 1981	x^b	x^9	o^{10}
20. $60,000,000 Seward Co., Kansas, October 1, 1981	x^b	$x^{1,11}$	x^2
MANUFACTURERS HANOVER TRUST COMPANY PUT BOND DEALS			
21. $50,000,000 Duval Co. Housing Finance Authority	x^a	x^{12}	o^{12}
22. $190,000,000 Louisiana Housing Finance Authority (\$100,000,000 option bonds) Dec. 1, 1981	x^a	x^{13}	o^{10}

NOTES

a No previous issue of Bonds by this Issuer.

b Was not in management group in previous issues of the Issuer in which no credit facility was supplied.

c Was in management group in previous issues because Bank agreed to provide Investment Agreement.

1 Letter of Credit Fee of .45% of aggregate amount of Option Bonds outstanding (not redeemed and retired by Issuer), payable semiannually in advance over life of issue plus Termination Fee equal to the difference between LOC fee at .45% and amount which would have been paid if LOC fee had been .56% over the life of the issue compounded semiannually at approximately 10%.

2 Bank has the right to invest substantially all funds and moneys under the Indenture/Resolution.

3 Terms not discernable from available data.

4 Letter of Credit fee of .45% of aggregate amount of Option Bonds outstanding payable semiannually in advance over life of issue.

5 Amount of Termination fee not discernable from data available.

6 Initial LOC fee of .5% of Option Bonds outstanding and semi-annual LOC fees of .5% of Option Bonds outstanding over life of issue.

7 Initial LOC fee of .45%; additional LOC fee of .0675% of Option Bonds outstanding payable on date of issuance.

8 Initial fee of $133,000; LOC fee of .45% of Option Bonds outstanding payable semiannually in advance; Termination fee equal to difference between LOC fee at .45% and .575% over life of issue.

9 Initial LOC fee of .0834% of Option Bonds outstanding times the number of months between delivery date and first interest payment date; LOC fee of .5% of Option Bonds outstanding payable semiannually for the life of the issue.

10 Investment Agreement awarded to another financial institution prior to Bank's entrance into the deal.

11 Initial LOC fee of .45% of Option Bonds outstanding.

12 Initial LOC fee of $2,000,000 payable at closing plus a percentage of the Option Bonds tendered payable semiannually in arrears. Tender option available to holders only from June 1 to July 1, 1986.

13 Initial LOC fee of $500,000 payable at closing plus a percentage of the Option Bonds tendered payable semiannually in arrears. Tender option available to holders only from June 1 to July 1, 1984.

TYING OF CREDIT FACILITIES ON HOUSING FINANCINGS (1980-1987)

The table lists for each bank the number of housing bond deals in which it participated as lead manager and the number and percentage of those deals in which it supplied the letter of credit.

Bank	Deals as Lead Manager	Deals Supplied Letter of Credit	Percent
Bank America	1	1	100.0 %
Bankers Trust	28	19	67.9
Chemical Bank	11	8	72.7
Citibank	29	27	93.1
First Interstate Bank of Cal.	5	5	100.0
FNB Boston	1	1	100.0
FNB Minneapolis	4	4	100.0
First Wisconsin	2	1	50.0
Manufacturers Hanover	7	7	100.0
Marine Midland	1	1	100.0
Mellon Bank	3	3	100.0
Security Pacific	51	45	88.2
Sovran	1	1	100.0
Wells Fargo	2	2	100.0
Totals	146	125	85.6

Source: Securities Data Company

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APPENDIX IV-C

"Conflicts of Interest

The rapid increase in the number of firms engaging in more than one type of investment business and the blurring of demarcation lines (for example, between brokers and jobbers) have made it more important than ever that investors are adequately protected against abuses arising from conflicts of interest within investment business."

DEFINITION AND PRACTICAL EXAMPLES

Definition

Stated in an abstract way, a conflict of interest situation arises for a bank -- or any other enterprise -- dealing with a client if it has a choice between two solutions for a deal, one of which is preferable from its own interest point of view while the other represents a better deal for the client. A conflict of interest situation arises also for a bank or another financial institution if it carries out activities involving two different groups of customers and if it has to strike a balance between the respective interests of the two customer groups. A practical example of the latter case is the new issuing, or underwriting, business which always requires a compromise between the interests of the issuer and those of the buyers of the securities. As soon as a financial institution -- or any other enterprise -- offers two or more technically or functionally unrelated services leaving scope for certain choices, it is faced with the problem of how much effort to put into the promotion of each of these different services.

As financial institutions often operate in a wide range of different financial services they are bound to be confronted with a relatively large number of conflict of interest situations. This explains why conflicts of interests in banking and finance generally receive more attention than in other sectors of the economy.

Practical examples and related concerns

The practical examples of conflict of interest situations listed below are, apart from the general conflict between banking and non-banking activities, grouped under two headings: first, conflicts of interest considered as typical of universal banks; second, conflicts of interest between different types of securities-related activities. The list is not intended to be exhaustive; nor is it intended to discuss the pros and cons of the arguments put forward.

Banking activities versus industrial and commercial activities

The principle of separation of "banking and commerce" which is applied

SOURCE: Organization For Economic Co-operation And Development, FINANCIAL MARKET TRENDS, November 1987, pp. 36-38.

in most countries to varying degrees in the sense that bank participations in industrial and commercial enterprises are either prohibited or severely restricted, is essentially based on conflict of interest considerations. A typical concern in this regard was expressed by the U.S. Congress in a House Committee Report of 1955 on the extension of the Bank Holding Company Act:

> "If banks were permitted to own non-banking businesses they would be compelled in many instances to extend credit to such businesses to the detriment of other competitive businesses in the community and possibly also to a degree which would be unsound from a banking point of view." (U.S. Congress, House Report 609, 84th Congress, 1st Session 1955.)

Conflict of Interest Situations Considered as Typical of Universal Banks Combining both Banking and Securities-Related Activities

Deposit business versus securities brokerage and related investment advisory business

It is sometimes feared that banks might promote deposit taking for balance-sheet growth reasons to the detriment of promoting household savings in the form of securities. The argument may, however, be reversed if banks were particularly interested in promoting their securities underwriting business.

Deposit business versus fund management (trust business i.e. the management of mutual funds, pension funds, and private securities portfolios on a discretionary basis)

...

Banks should not be allowed to use managed funds for strengthening their own deposit base.

Combination of corporate credit business and securities brokerage and investment advisory services and security trading on own acount

Banks should not be allowed to influence their securities business with clients (brokerage and investment advice) or their securities trading business (on own account) through company information obtained in connection with lending activities.

Corporate credit business versus new issuing (underwriting) business

Critics of this combination of activities fear that universal banks would unduly favour their credit business with corporate clients for profit and balance-sheet growth considerations to the detriment of the development of an efficient corporate bond and equity market.

Combination of credit business with private customers and securities brokerage and investment advisory services, security trading on own account and underwriting business

Banks should not unduly encourage private securities purchases via imprudent lending to private customers to finance such purchases.

SOURCE: Organization For Economic Co-operation And Development, FINANCIAL MARKET TRENDS, November 1987, pp. 36-38.

Conflict between the banks' involvement in industrial and commercial enterprises via participations, proxy voting rights and mutual interlocking membership on supervisory boards and their securities business with private customers

Banks should not abuse their relationships with industrial and commercial enterprises against the interests of small and minority shareholders.

Conflicts of Interest Between Different Types of Securities-Related Activities

Combination of securities brokerage (agency) business and dealing on own account (jobbing, market making)

Securities firms or securities departments of universal banks should not unduly benefit from serving client orders from their own books.

Combination of security dealing on own account (jobbing, market making) and trust business (fund management for pension funds, mutual funds and discretionary portfolio management for private persons)

The market making function should not be based on security holdings managed under trust business. Undesirable own holdings of securities should not be dumped into funds under management.

Combination of new issuing (underwriting) business and trust business (fund management for pension funds, mutual funds and discretionary portfolio management for private persons)

The new issuing departments of securities firms or universal banks should not be allowed to demonstrate their placing power by dumping low-quality issues or not adequately priced issues into funds under management. Conversely, funds under management should not unduly benefit from the pricing of new issues to the detriment of issuers.

Combination of investment research and securities trading on own account (jobbing, market making)

Securities trading on own account should not benefit in an unfair manner from early information on purchase recommendations to be released by investment research departments.

Combination of investment advisory services and securities brokerage business

Investment advice should not be biased in favour of overtrading ("churning") i.e. unnecessarily high turnover of the securities portfolio of private clients intended to generate high fee income.

SOURCE: Organization For Economic Co-operation And Development, FINANCIAL MARKET TRENDS, November 1987, pp. 36-38.

The CHAIRMAN. Thank you, Mr. O'Brien.

Mr. Bachmann.

STATEMENT OF JOHN BACHMANN, CHAIRMAN OF THE BOARD, SECURITIES INDUSTRY ASSOCIATION, NEW YORK

Mr. BACHMANN. I am John Bachmann, the managing principal of Edward D. Jones and Co. We are an investment firm based in St. Louis with 1,350 full service offices in 37 States.

SIA believes that the separation of banking and securities has served us well. I think the question before this group is what form should we take now as we move forward and I think we recognize there have been changes in technology, international competition, consumer needs, inflation, interest rates—there are a myriad of issues that did not exist at the time of Glass-Steagall and so it's altogether appropriate that we rethink the issue.

I think there are three problems that we have difficulty with—certainly I have difficulty with. First, it would appear from a public policy standpoint that we would probably be expanding the Federal safety net.

UNFAIR COMPETITION

From the standpoint of competition, our point of view would be that S. 1886 increases unfair competition and I think it also raises some consumer issues.

I would like to touch on a few of those, if I might, from the experience of my firm and others.

As you know, there is little regulation today of securities activities in banks, and we have run into some situations that underscore those competitive difficulties. We have had situations where bank officers, when a large check cleared from particular customers, actually went out to see the customers to see if they could persuade them to not honor the check, to stop payment on the check. We have run into situations where the banks are going through our checks and using those as a basis for calling our customers to offer the identical services. We find this a very difficult form of competition for us to deal with.

I guess if we were to compare that to anything, it would be like reading somebody else's confidential mail. From a competitive standpoint, it's extremely difficult.

We find in advertising that there's very little regulation in much of the advertising today. The use of the FDIC imprimatur conveys something that is not there in many cases because there are securities transactions that the banks engage in that clearly are not insured by the FDIC. They are also not insured by FSLIC and yet there's an impression that there is some form of insurance that's covering those securities transactions.

We also find that there's a lot of partial information in some of the advertising that, by our industry standard, would cause a securities firm to get into severe difficulties with the regulators.

We also find that prospectus items are advertised rather carelessly. That can take the form of failing to mention that a prospectus must be delivered in the transaction. We also find that discount activities are coupled with prospectus offerings in one ad implying that if you buy the mutual fund or unit trust in these particular institutions you would be able to get them at some sort of a discount, a violation of SRO rules.

We can't really blame the banks. The banks simply do not have this regulatory oversight. Furthermore, in many cases they are not familiar with the rules. It does frustrate us, though, that when ads are run saying "Trade your broker for your bank." The person a customer would be doing business with at the bank has no qualifying exam to prepare them to help that customer.

So under the law as it exists now, the SEC is precluded from seeing that these issues are addressed.

Leading on to the three bills, the Financial Modernization Act of 1987 and the Financial Services Oversight Act. To a greater or lesser degree, we believe they screen out securities firms—many of our securities firms. In terms of industry coverage, there would be a very high percentage of the coverage that we fear would be screened out because of their relationships with other institutions.

It's a little bit like the story in Mother Goose where the fox invited the stork to dine but he served the meal in a bowl and, of course, the fox left well fed and the stork left hungry. It was there, but it was just in a form that made it very difficult for the stork to participate. We see, as we look at it, no major banks that have been left out if the legislation passes; yet we find that a large percentage of our members would be left out. It has to concern us when we look at the period from 1927 to 1929. We see that as banks became involved in the securities underwriting business in the course of 3 years they increased their share of the business from about one-third to two-thirds, So that is distressing.

As far as the Depository Institutions Affiliation Act is concerned, it seems that from the standpoint of the two-way street that it probably comes closer to providing us equal access or cross-access to one another's business.

Now our solution would be, if the Congress is determined to act, that we should start by creating some sort of a firewall. Start by segregating the present securities activities that the banks are engaged in so that there can be a period of time to find out how these things should be structured, to find out how the regulation works, to find out how they should be administered. It could be a step-by-step process.

I think it would include both domestic and foreign business. I think it would involve them adhering to the same rules as securities firms do in terms of their capital, in terms of their supervision, in terms of their taxation, the examination process and so forth.

We think that to move slowly makes sense and yet it would give a period of time for the Senate Banking Committee, the House Banking Committee and the Committee on Energy and Commerce to really examine how the financial services should unfold. I think the main test should be what's right for the consumer, what's right for the taxpayer, and what's right for the national interest. It should not be based on the securities industry, the banking industry or any other industry. Then if anything we come up with is flawed, it really does not become a long-term solution.

I think such a proposal would get things moving. I think it would do it with a minimum of risk and I think as events unfolded we would find that the most difficult problems to deal with are not the technical problems but the human problems. I think the result can be that we can see an orderly development of our Nation's financial services system and one that creates a system that ends up where we should be. I guess I'm optimistic about that.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Bachmann. Thank all of you gentlemen for your excellent testimony.

Mr. Silver, you gave us a very interesting history lesson indicating that we have forgotten what happened more than 54 years ago when the Glass-Steagall Act was passed.

We had an earlier history lesson in July of this year when Professor Perkins of the University of Southern California, who is a scholar who has made a study of this, said that after the 1933 enactment of Glass-Steagall, curiously, Glass was among those who only 2 years later began to have second thoughts about the necessity of such a drastic uncompromising step. The earliest versions of the Banking Act of 1935 which passed both Houses of Congress before going to the conference committee that Glass chaired on the Senate side included provisions which would have permitted commercial banks to reenter the investment field as underwriters of corporate securities as wholesalers but not as retailers. Glass conferred with President Roosevelt in August 1935 and the President made absolutely clear his adamant opposition to any changes in the existing law regarding the separation of the two banking functions. So Glass removed the offending section of the bill in favor of softening the divorce provisions as early as 1935. These were the same people, by and large, and they wanted to soften those so-called divorce provisions at that time.

CONSIDERING THE FACTS

So I wonder if our memory is so short or if we aren't also reconsidering this on the basis of sound historical advice and testimony we have had before the committee.

Mr. SILVER. Senator, first I would observe Congress did this in 1935. Second, I would observe I'm glad you quoted Professor Perkins and that you do not necessarily share that view, but the fact is that Senator Glass modified his position in one very limited respect and that was that the banks could hold in their own investment accounts corporate debt. In order to hold corporate debt, naturally they had to be able to sell that debt in wholesale or block transactions. There was no intent to permit the banks to become underwriters of that corporate debt. There was no intent to permit them to retail that corporate debt. There was only an attempt by Senator Glass that banks be permitted to hold those as investments.

The CHAIRMAN. I think Professor Perkins would disagree with that view. He says that what was included in that 1935 bill included provisions which would have permitted commercial banks to reenter the investment field as underwriters of corporate debt. Now those are his words. He testified on July 30, 1987, right here.

Mr. O'Brien, you say on page 4 of your prepared testimony, "With the expiration of the moratorium approaching, Congress must decide how to proceed in a safe and sane manner." That sounds to me like a clear recommendation that the moratorium on expanded powers for banks imposed by the Competitive Equality Banking Act should be extended.

Is that correct? Does the SIA recommend an extension of the moratorium?

Mr. O'BRIEN. SIA would take the position, Senator, that this process which is now proceeding should continue to proceed.

The CHAIRMAN. Please answer the question.

Mr. O'BRIEN. Let me finish. What I'm saying has several parts to it.

First of all, the reassertion of congressional rights is the right thing to do, which you should not give away. And that means that if the process can be completed by March 1 and that's possible, then the process should be completed, and there will be no need for the extension of the moratorium.

But if the process seems to be not ready to be completed but is showing some progress, then I would think that the prudent thing would be for the Congress, this committee, and the House, to continue this developmental process and give itself sufficient time to do it.

I don't think that the Congress should be put in the position where it is in reality, or perceived to be, permitting a dilatory tactic. That's not the SIA position certainly. But if the process seems to be proceeding if it takes a few more months, 6 months, 5 months, whatever it is, I think you should do it.

The CHAIRMAN. But Congress specifically says in section 203 of the Competitive Equality Banking Act that we passed that Congress will not extend the moratorium. We made that promise. We made that pledge. We said so in the act, that we would not extend it.

Mr. O'BRIEN. Yes, you did, and I think that promises made by the Congress should be taken seriously by both the citizens and by the Congress. And I think they are. But I think the Congress' job is to legislate and if legislation appears to be in the offing in some intelligent way, I personally would not be bound and I would suggest that you should not be bound by something which would prevent you from bringing about a decent result.

The CHAIRMAN. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Gentlemen, I'm well aware of SIA's love affair with Glass-Steagall all of these years. That's been evident in your testimony. I suppose I feel as I listen to your testimony like I do about the tobacco industry that still won't admit that cigarette smoking is hazardous to your health. I'm appalled that they are able to come and testify before other committees to that effect. And I'm still amazed that you can come and ask for fairness and a two-way street when it simply is not.

GLASS-STEAGALL WAS MEANT TO SEPARATE BUSINESSES

Now wouldn't you agree, Mr. O'Brien, that Glass-Steagall was a two-way street? It prohibited securities firms from being in the banking business and commercial banks from being in investment banking. Is that correct?

Mr. O'BRIEN. Yes. I think it was intended to build a separation between the two.

Senator GARN. Absolutely. We agree on that.

Mr. O'BRIEN. And it was for a good reason which, in my judgment, still exists.

Senator GARN. But when I hear your testimony that banks should not be allowed in the securities business for all the safety and soundness and prudence reasons, it makes me look at a list of the ten top securities firms, nine of which own nonbank banks that are federally insured depository institutions with all the protections of the Federal Safety Act. E.F. Hutton owns the E.F. Hutton Bank; Dean Witter owns Greenwood Trust and Hurley State Bank; Prudential Bache owns Prudential Bank and Trust Co.—even the same name, no confusion there I guess, no tie-ins. Others include First Boston Universal Trust, Drexel Burnham Commercial Trust Co., and so on.

You know where I'm coming from. If you want to be fair, do you favor divestiture of nonbank banks along with extending the moratorium on banks' securities powers? If we're going to have a two-way street, which is what I have always been for, then if we are going to continue a moratorium while we have our usual one hearing a year for 25 years and finally come to a conclusion, is it not also fair to have a bill that says, OK, let's go back to the original Glass-Steagall, with no securities firm involvement in the banking business? Shouldn't we go back to the original intent, because I can show you the testimony and we know what the testimony was, but the securities industry side of it has violated that intent. And I cannot believe in good conscience that SIA can sit here and give the testimony you give year after year, which I would not object to if the securities industry was not so overwhelmingly involved in the banking business.

So let's get back. Two ways to go. I will accept your testimony if you will agree that if we can't complete a bill by March 1, you will support a bill to divest the securities industry of all of its banking activities while we take this step-by-step approach. Your reaction?

Mr. O'BRIEN. Well, Senator, you've heard from me so often, you will now have the chance to hear from John Bachmann.

Senator GARN. Mr. Bachmann, wouldn't that be fair and equitable, a two-way street like Glass-Steagall intended?

Mr. BACHMANN. I think a true two-way street with the proper safeguards is—if you can come up with that, it's hard to argue with.

My concern is this, Senator——

Senator GARN. Well, do you believe in a bill to divest securities firms of their banking interests while we wait to decide this grave question over the next 50 years?

Mr. BACHMANN. I don't think it should take—I'm getting questions in front of me so fast I don't know which one to answer first.

Senator GARN. Just answer the simple question I asked you. Do you believe in a divestiture bill? Should E.F. Hutton get rid of the E.F. Hutton Bank?

Mr. **Bachmann**. What I'd like to say is, from my standpoint, nothing—and I'm speaking for myself now—would please me more than to see this issue resolved. To see us use up the resources of our industry year after year after year when we have urgent questions on things like October 19 that we should be addressing, and yet we have to focus on this, it's not the wisest use of our resources over time. There's no question about that.

The difficulty we have, that I have—because we focus so much on the investment banking issue, there's very little focus on the retail securities industry, and in the world that I'm a part of and other retail firms are a part of, the banks have been granted powers by regulators who have the ability to grant those powers.

The bank regulators are concerned with safety and soundness of the banking system and in their eyes at times creating more powers, getting in other businesses, is attractive.

Our regulator simply is charged with investor protection. We do not have the means to get into many of those businesses. We cannot grant credit.

Senator **Garn**. Mr. Bachmann, I agree with you. Congress should legislate. For 13 years, Ed O'Brien and everybody knows that I have been trying to get Congress to legislate. Regulators and courts should not do it. So we agree on that.

Is it fair for the securities industry to own federally insured banks, participate fully in the banking business, while preventing banks from getting into securities, if we're going to have a two-way street? Just answer my question.

Mr. **Bachmann**. I think that it is fair to get them to divest if you can get the banks to divest the securities activities they are presently conducting. I think that would be perfectly fair.

The problem is we've gone too far and the solution is not going to be found in that. The solution is going to be found, I think, in coming up with ways to provide the protection.

Senator **Garn**. In the meantime, it's fair, in your opinion, to try through a moratorium to stop any additional incursion of banks into the securities business while the securities business continues to own all of their banks and third party checking and the whole thing? That's fair?

Mr. **Bachmann**. But the banks are continuing to conduct the securities activities. We're not talking about not doing the activities they are already doing. They are selling mutual funds, securities in a trust over the counter in the towns that my firm does business in, and they do that every day. That's not slowing down. I don't see where that's changing. And I'm not unsympathetic to——

Senator **Garn**. I would be embarrassed to talk about two-way streets and have the securities industry so heavily involved in banking. One way or another, some day—I hope I live long enough to see it solved one way or the other—Congress should either let the banks in the securities business or get you out of it, one or the other.

The **Chairman**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

I've always kind of liked Glass-Steagall and I know there are differences of opinion around the table on that question and clearly the world has changed and is changing. And it seems to me that one of the things that Senator Garn puts out on the table here is the issue of encroachment both ways. I think we've seen that. Now the question of who started it and what was in response to what I think we could debate that for a very long period of time, but you don't have a clean situation either way. You've got penetration in both directions—banks into the securities business and securities firms broadly defined on over into the banking business in different ways.

And it is that ambiguity—it is that sort of middle zone of cross-connection here that complicates this issue enormously. And that is against the backdrop of all the deeper, long-term fundamental issues that we've been discussing here for such a long time and discussing here this morning.

I do think that there is a requirement on the part of everybody in this debate—and I don't just say this to you, I say it to the banking representatives here earlier and anybody else that will come in the past or the future—to address that question. In other words, we've got a very fuzzy mixed situation in part today.

The question is, how do we deal with that? Some would say try to back up, divest, set the clean line. Some would say go forward, comingle, functional regulation, firewalls and so forth.

It seems to me that if somebody wants to argue the middle position and that is to let's try to freeze it to where we are today even with the ambiguities, then there has to be a whole rationale and set of definitions and ground rules and approach that goes with that.

I'm not sure I've heard that yet from anybody. I don't say this just to this panel but to anybody else. And, of course, it raises the question that even if you want to stop right where we are now with the ambiguities, is it possible to do so, or are market pressures, regulators' decisions, court cases and everything else sort of moving us down the road into an ever-more mixed situation?

I think what we're going to have to have here, and particularly from those folks who—and I think this does apply to this panel—who say that they don't want to see the bills that have been put before the committee move forward, then I think there has to be a far more complete setting forward of an approach that really rationalizes reality today and rationalizes the kinds of ambiguities that the Senator from Utah points out.

I don't think it's sufficient to say that those things are there and yet we really don't have an answer for it and yet we don't want something else. I don't think that is a workable position.

Now where we go from there I think is very hard. It's very hard to move in the question of how do you take and resolve the ambiguities and keep the ambiguities from continuing to multiply? That's the issue.

The thing that I care about most in the end is what serves the public interest and I'm not out to advantage or disadvantage any of the parties at interest that are out in the private sector in this area. But I am profoundly concerned about the question of what serves the public interest, what maintains safety and soundness in terms of anything that has to do with a Federal deposit guarantee. I'm very much concerned with maintaining the efficiency of the capital markets so that we can save and we can take and rotate

APPENDIX V-A

Selected SIA Member Firms
Wholly Owned by Outside Organizations

- Included below are only those firms where owner is not engaged primarily in the securities industry.
- Shown in parentheses following the firm is its capital rank.
- Where shown, the firm name in parentheses is the parent of the broker-dealer.

Broker-Dealer	Owned By
Angeles Securities Corporation (201)	Angeles Corporation
BLN Investment Corp. (334)	Bankers Life Insurance Company of Nebraska
Blunt Ellis & Loewi Incorporated (58) (Loewi Financial Companies Ltd.)	Kemper Financial Companies, In
Boettcher & Company, Inc. (81) (Beottcher Investment Corp.)	Kemper Financial Companies, In
Calvert Securities Corporation (218) (Claver Group, Ltd)	Acacia Financial Corporation
Citizens and Southern Securities Corporation (253)	Citizens and Southern Corp.
Dean Witter Reynolds Inc. (8)	Sears Roebuck and Co.
Deltec Securities Corporation (205)	Deltec Panamercia S.A.

Source: Securities Industry Association Yearbook, 1987.

Broker-Dealer	Owned By
R. G. Dickinson & Co. (184) (Statesman Group Inc)	Statesman Financial Services
Dillon, Read & Co. (24)	The Travelers Corporation
Donaldson, Lufkin & Jenrette Securities Corporation (12) (Donaldson, Lufkin & Jenrette, Inc.)	The Equitable Life Assurance Society of the U. S.
Eppler Guerin & Turner, Inc. (83) (EGT Financial Corp.)	The Principal Financial Group, Inc.
Federated Securities Corp. (77) (Federated Investors, Inc.)	Aetna Life & Casualty Company
FSC Securities Corporation (N/G)	Mutual Life Insurance Company of New York
W S Griffith & Co Inc (298)	HLI Corp. (Home Life Insurance Corporation)
IDS Securities Corporation (317) (IDS Financial Corporation)	American Express Company
INC Trading Corporation (310)	Instinet Corporation
Janney Montgomery Scott Inc. (48)	Penn Mutual Life Insurance Co.
Kemper Financial Services, Inc. (N/G)	Kemper Financial Companies, Inc.
Kidder, Peabody & Co., Inc.	General Electric Financial Services
Kirkpatrick, Pettis, Smith, Polian Inc. (196)	Mutual of Omaha Insurance Company
Lovett Mitchell Webb & Garrison, Inc. (216) (Gulf Texas Capital Corporation)	Kemper Financial Companies, Inc.

Source: Securities Industry Association Yearbook, 1987.

Broker-Dealer	Owned By
MKI Securities Corp. (87) (MKI Investments, Inc.)	International City Hol
John Nuveen & Co. Incorporated (25)	St. Paul Fire and Mari Insurance Co.
Prescott, Ball & Turben, Inc. (41)	Kemper Financial Compa
Prudential-Bache Securities Inc. (7) (Prudential Securities Group Inc.)	The Prudential Insuran of America
The Robinson-Humphrey Company, Inc. (66) (Shearson Lehman Brothers, Inc)	American Express Compa
Securities Settlement Corporation (57)	The Travelers Corporat
H. B. Shaine & Co., Inc. (259)	DST Systems, Inc. (50%) Pioneer Western Corp.
Standard & Poors Securities, Inc. (181)	Standard & Poors Corpo
Sutro & Co. Incorporated (165)	John Hancock Freedom S rities, Inc.
Tucker, Anthony & R. L. Day, Inc. (67)	John Hancock Mutual Li Insurance Co.
USLIFE Equity Corporation (240)	USLIFE Corporation
Van Kampen Merritt, Inc. (21)	Xerox Financial Servic
Wall Street Clearing Company (140)	Barclays de Zoete Wedd Barclays Bank PLC
S. G. Warburg Securities (51)	Mercury International
The Westcap Corporation (158)	National Western Life Insurance Co.

3064m

Source: Securities Industry Association Yearbook, 1987.

APPENDIX VI

QUESTIONS CONGRESS SHOULD ASK

- How can the rest of us be protected against the unfair tying arrangements that banks constantly deal in but are rarely caught at? The situation will be worse the more activities outside of banking they can be engaged in.

- What kind of problems will these new ventures create for the banking system as a whole?

- How can we shield banks, the insured deposits of investors, the U.S. Treasury and the taxpayers from the cyclicality and volatility of the securities business?

- Who can own a financial services holding company?

- Who will regulate a financial services holding company? Who will regulate securities affiliates? How complicated will the new regulatory arrangement have to be to take care of this much more complicated set of structures?

- How will conflicts be handled within the structure, and will simple disclosure work? Will secrecy about internal bank problems continue to be the order of the day?

- How do we neutralize the cost-of-money advantages that banks have?

- How do we ensure that other financial institutions will not be subjected to unfair bank competition?

- How do we initially capitalize subsidiaries or affiliates? How do we gauge capital adequacy for banking and the other permitted ventures? How do we isolate banking capital so that it will be available for banking purposes?

- How do we provide continuing capital for the new securities affiliate, since clearly it would be unfai for it to obtain it from an affiliated bank? Will th problems presented by "double-leveraging" be compound

- What role do nonbank banks play within the structure?

- Should national treatment vis-a-vis Japan and Germany be resolved in this system? Should change in Glass-Steagall be coordinated with changes in Japan's Article 65?

- What advantages are there for the public, the consume and business in these changes?

- What benefit is there for industries that will now be faced with bank competition in their businesses? Should they be granted power to enter banking?

- What impact will these changes have on control of monetary policy?

- Should all Glass-Steagall loopholes be plugged so as bring all financial institutions under the same rules including state-chartered insured banks and thrifts?

- How do we ensure that allowing banks into new fields will be pro-competitive and not just a step on the ro to greater concentration of financial power?

- Banks claim they need new powers to remain profitable. Are banks really unprofitable? Recent evidence would suggest that they are not.

- Are domestic banks really uncompetitive internationally? U.S. banks rate high in the world in terms of profitability. Asset growth of Japanese bank is largely a result of the increased value of the yen.

- What are the real problems within the banking system?

- Are there banking problems that cannot be solved within the present banking structure? Why is it that so many well-run banks are doing well if there are structural problems? Is securities underwriting the answer for agricultural and energy loan problems?

- Why cannot banks meet consumer needs under the current banking system?

- Do we really want to trade a diverse and varied financial system for a universal banking system with the economic power concentrated in the hands of a few?

- What would be the effect on consumers and small and medium-sized businesses if banks are allowed to go afield from banking?

- Can we imagine a better result from any other set-up than Glass-Steagall has given us: a sound banking system, capital markets second to none and financial power spread across two separate industries?

that money and invest it and get it out into the community to create the kind of economic growth we need.

We obviously need a well functioning financial securities market system. I am distressed by the story in the paper today as more of these study groups are done on what happened on the 19th about the breakdown of the system and the markets sort of being able to function, credit through retail activity.

So it seems to me that what we're going to need to have here is something that is more clearcut and I think it's time to try to fashion whatever that clearcut notion is and I don't think we can do that if we just ignore all of the realities that have piled up. I think those realities now have to be sorted out and they have to be rationalized in some fair form.

If we can do that on a ground that serves the public interest and that allows each of the industry groupings to be able to function in their own right and do what they do best, then that seems to me to come as close as we can come to a solution.

I make these comments, Mr. Chairman—the 5-minute time period doesn't give us much here, but I think the reasoning process here is as important as the question of the cross-examination and I, for one, am trying to reason my way through the question of how we answer some of these questions.

RISKS OF UNIFICATION

The one question that I do want the panel to respond to is the question of what are the inherent risks of the securities business, the investment business, that we would be transferring into the banking system in the event that we go ahead and go with a total unification of commercial banking and investment banking and the securities business? What are the risks that come on over into banking that we would have to acknowledge and be prepared to accept?

Mr. O'Brien. I'll begin if I may, Senator, but before I do, I just want to make one point. I agree with what I understand you to say, which is that there must be some sort of a rationalizing of the process. And I concluded my own comments somewhat along the same line, which was that we believe that Glass-Steagall has efficacy. If the choice is being made by the Members of the Congress to do something about Glass-Steagall for a variety of reasons, then we have suggested a process here which would enable that process to go forward, drawing upon the legislative proposals which have been presented so far.

As far as the risks are concerned, all I can say is that based again on my 32 years—and then John and Dave will amplify on it—the risks in the securities industry have mounted substantially in the last several years. In 1978, the commission business was overtaken by the risk business as the predominant part of the revenue stream in the securities industry.

That meant that while the simple commission business was relatively risk-free, that the positioning business, the trading positions and so on, were now the principal source of revenue in the securities industry for a variety of reasons, which we could go into if we had more time. That means we required more capital, that the risks were substantially higher, that the market variations were and could be cataclysmic in certain areas.

So that is the type of thing which, by the way, was reflected on October 19 and 20. It isn't just the 19th—that is the type of risk that strikes our industry. Despite all efforts to hedge and to limit risks, that is the type of risk that would move over into the banking industry.

And before I leave and turn it to John or to Dave, I should also mention that Bob Downey is here. He is a partner of Goldman Sachs and he deals with risks every day right on the line, and he has some good reasons to demonstrate how you can lose your shirt. I hope not too graphic, Bob.

Mr. SILVER. Senator, if I may also take a shot at that, I would add to what Ed says by saying that my concerns of the risks are really in two areas. One, that of public perception. You had that in the 1920's. You also had that in the 1970's with the REIT's. When Chase brought its REIT out to the public, there was a press conference in which Chase used its name to lend additional credibility and stability and solidity to its REIT. After Chase poured in, when the market turned, $250 million or $500 million or $750 million, to salvage the REIT—nobody really knows the amount—in the ultimate settlement of that case, one of the conditions stipulated by the court was the REIT, could no longer use the Chase name. That was insisted upon by Chase as one of the stipulations of settlement.

That in itself I think tells the story. It is the public's perceptive. Mr. Wriston is always candid and he was right when he said that a bank will always act to prevent the failure of an affiliate. That is a given and that given I think you have to grapple with to solve this difficult question.

Second, I am deeply concerned about integrated financial institutions and fragmented regulation. I don't like megafinancial institutions. I probably like megaregulators even less. Somehow, however, you have got to provide for close coordination of the existing regulatory agencies if in fact you don't move in the direction of creating a megaregulator.

I see that two of the bills that have been introduced move in that direction, albeit in very rudimentary fashion. But too many matters can fall between the cracks when you're dealing with integrated financial institutions and products which actually cross the traditional boundary lines. I don't see how, as a matter of logic, you can use the integration of financial products, and the presumed necessity for integrating the financial institutions themselves, as a predicate for legislation and at the same time remain content to see the regulators move in very, very narrow circles within their traditional jurisdictions.

Mr. BACHMANN. I think, basically, what we are confronted with, as far as risk, is one of the things that the bankers spoke of earlier this morning. You see a constant downward pressure, or an erosion of profit margins, and it forces people to take more risk. Clearly, in the securities industry, it has taken us from an agency business to a principal business, where we are taking on far more risk that we were in the past, in order to try to salvage, or in some cases, closely maintain profitability. We do it at a time of dramatically increased volatility. You know, the suggestion is made, well, the underwriting business isn't that risky, but the underwriting business is. You're not going to be an underwriter, if you're not going to be a market maker. That means that when the large institutions want to sell when the dark clouds are on the horizon, I think you're going to find yourself a very large net buyer of securities. I'm sure Bob Downey's got the scars to prove that.

You also have, and this is where it's difficult for us, there is a perception and, in fact, there's been a reality, that large banks can't fail. So it means that whatever that veil has been, it's been penetrated. What we are talking about is, how do we create a wall rather than a veil to separate these activities, so you are not using basically Government-guaranteed funds to finance one of the players. It seems to me that we've had situations where we have seen an affiliate get in trouble, and we have seen the instinctive reaction of the parent in that situation. We've also seen the treatment of major losses by a large financial institution in the Midwest, where they were able, because of the different tax treatment, not to mark those losses to the market, but rather to simply treat them as a long-term investment. You're talking about in excess of a half a billion dollars in those transactions, and those are very real risks. I don't know if you can say, well, these things we are going to mark to market, and these things we are really going to decide, instead of marking them to the market, we are going to treat them as portfolio investments. That really, I think, underscores some of the areas of risk, as I see them.

Senator RIEGLE. Thank you.

The CHAIRMAN. Thank you, gentlemen.

Mr. DOWNEY. May I just add little more to this?

The CHAIRMAN. Sure.

Mr. DOWNEY. I am a partner of Goldman Sachs, Mr. Chairman and Senators, but I also am vice chairman of SIA. I think I should speak with respect to risk in my capacity as a partner of Goldman Sachs. We were lead underwriter in America for the BP, British Petroleum issue that took place about a month ago, and the aggregate losses in that one issue were $1.7 billion for all the underwriters, for which about $300 million or $400 million were suffered by the American underwriters. So I think the way I'd put it is, that wiped out a generation of underwriting profits. So that, I think, is evidence alone of the risk in underwriting. Certainly, in the market making, as John alluded to, certainly on Black Monday and other days, any market maker took very large hits. And I think the worry is, with the banks getting into the business that it would add incremental risks. Certainly, lending is risk, but underwriting securities is terribly risky as well.

I would like to make one other observation, and that is to Senator Garn's point that 9 of the 10 largest securities firms own nonbank banks. I think you will find, Senator, that most of the firms that own those nonbank banks never wanted to own a nonbank bank, and I'll use ourselves as an example. We did it as a safety precaution, and we've never, gone forward and done business. We were afraid that there might be some kind of grandfathering. The grandfathering that took place by the Senate was for operations. You had to have a certain operational capacity to qualify. So ours does us no good, and I am sure other people's nonbank banks do them no good. We'd gladly get rid of it tomorrow. The only fear is, maybe someone would let more people be in the banking business. How will we compete with the nonbank banks that are able to operate?

But we are not really worried about that, if you stop it here, if you don't add any more. I think Chairman Volcker said, testifying before you last year, that the nonbank banks only amount to 2 percent or less of the deposits. So that doesn't really scare us, and I don't think it scares the banks very much. And where they are growth limited and limited only to those few who are at a reasonable activity at the time of your bill last year, I don't think it is a major thing at all. As far as we're concerned, we wish they didn't have them. Even a very, very small nonbank bank is still competition. In a perfect world, why have them? I would agree with that. We will get rid of ours.

The **CHAIRMAN**. Senator D'Amato.

Senator **D'AMATO**. Thank you, Mr. Chairman. I had this very cogent, powerful statement, Mr. Chairman, but in the interests of time, I'd ask that it be submitted to the record, as if read in its entirety.

The **CHAIRMAN**. Without objection, so ordered. [Laughter.]

Senator **D'AMATO**. Oh! Would you like to hear it, John?

Senator **CHAFEE**. You have got me tilting here, but I think I'll [laughter] I'd like to put mine in too.

The **CHAIRMAN**. Without objection, Senator Chafee's statement will be put in, in full too. Senator D'Amato.

WHICH BILL WOULD YOU ENDORSE

Senator **D'AMATO**. I am wondering if I might ask the panelists, starting with Mr. Silver, if you were given the option of endorsing only one of the bills before the committee——[Laughter.]

Senator **GARN**. Which poison cup would you like?

Senator **D'AMATO** [continuing]. S. 1886, S. 1891, or S. 1905, which would you endorse, and in 30 seconds or less, why?

Mr. **SILVER**. I should have left. [Laughter.]

I think, Senator, not because you asked the question, but if I were given that very unpleasant choice, and I think—and Senator Garn's home State is one of the few States that gives the convicted murderer his choice of hanging or being shot—and I do look at this——

Senator **GARN**. No, we've added lethal injection too. [Laughter.]

Mr. **SILVER**. I'm glad you've kept up with the latest technology. [Laughter.]

I think, Senator, if we are going to go down the road of financial integration, let's go all the way. I think that we have got to be very, very aware of the kind of things that Chairman Ruder talked about, as far as adding vitally important protections. I do feel the kind of nostalgia that Jerry Corrigan and Chairman Volcker have for a world in which banking and commerce are separated, but if there has been integration across the fences, the integration has not only been in the financial services section but the integration has been right across the line. GMAC and other kinds of financial activities on the part of corporations have long been accepted in this country, so that if you are going to go on the road of integration, I would prefer your approach, but I would say, under the most stringent kinds of safeguards.

Senator D'AMATO. Mr. O'Brien?

Mr. O'BRIEN. Well, Senator, I don't know whether I will accept the lethal injection or something else, but I would use Senator Chafee's term, and I would tilt in your direction, if I can put it that way.

That is not to disparage the other bills, and I'm not just saying that, because, as I said before, I think that the bills represent a process which is very, very important. I don't think either one of them or any of them do the job to my satisfaction, but the process of moving forward is the way to go, as far as I can see it.

Now to do the very good job, you should couple it with our approach. Some firewalls and some flexibility, will enable you to develop legislation over the coming years, because the world is not going to stand still in 1990, any more than it has in 1987.

Senator D'AMATO. Mr. Bachmann?

Mr. BACHMANN. Well, I end up at the same place, and I go back to my statement earlier that it would appear that under the other two pieces of legislation, as I think Senator Garn himself pointed out, it does not provide the degree of a two-way street that is in the legislation that you've proposed. I think from the standpoint of our members, that would be the one that would enable most of them to participate—enable all of them to participate.

Senator D'AMATO. Mr. Downey?

Mr. DOWNEY. Senator, I think that that's where the Nation might eventually end up a few years from now, perhaps. But I don't see how that's really possible. Even though it's my best choice, first of all, of the three offered, I don't see how that's really possible by March 1. But if you were to adopt our suggestion, which is, take all the existing securities powers of banks and put them in an affiliate and stop the regulator from offering powers and keep this in control of Congress. Then if you give a power, beyond the ones that they have—and see how that works, then maybe you would revisit it 6 months from now and give them another power, if the firewalls work, Senator.

Senator D'AMATO. Well, let me make my position clear; first, this Senator would not be in favor of that approach. Second, it would seem to me that if we were actively engaged in a process that would lead to the completion of a legislative package, that the regulators certainly would get that message and would not take precipitous action.

So I'm not so concerned about the regulators. If it came to a situation where they could see that Congress was not going to move, and I'm not for extending that moratorium. I think we need the deadline to keep the process moving, and I think—I am going to serve notice, this Senator is not engaged in the process of attempting to provide additional time vis-a-vis extension of the moratorium. And I think you had better wake up to that. I think you had better begin to become part of that process of seeing to it that you are really participating in what the final legislation will be.

And I thank the Chairman, and I thank the members of the panel.

The CHAIRMAN. Thank you. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Bachmann, you raised some questions as to whether we were focusing our attention on the right issues that we may be dealing with, lesser significant questions, to the detriment of what our true agenda should be.

If you could write the agenda of what the Congress should be attending to in the next 12 months, what would you include?

Mr. BACHMANN. You mean from the standpoint of this legislation?

PRIMARY OBJECTIVES

Senator GRAHAM. From the standpoint of dealing with what you consider to be the primary problem areas in America's financial institutional structure, what do you think our priority objectives should be?

Mr. BACHMANN. OK. I think—in my view, you have to start with the consumer. You start with the customer, and you work back from there. You look at what serves the customer's interest. And second, the taxpayer, because, to the extent that you are going to have disasters, the taxpayer always mops up afterward. You know, a lot of us have a lot of money in a bank in Chicago we never intended to, because it had to be done. It was, in my mind, clearly in the national interest, but——

Senator GRAHAM. Excuse me, Mr. Bachmann, that is not taxpayers' money. Those are premiums paid by the member institutions. I read an article the other day that talked about how we bailed out with taxpayers' money, heard it on the nightly news, that big savings and loan. So that is not a taxpayer burden. Excuse me for interrupting, but that comes from the insurance premiums of the FDIC or the FSLIC, as the case may be.

Mr. BACHMANN. OK. Well, I stand corrected on that.

As far as—it seems to me we should start with what serves the customer. The key issues you have to look at include technology where it fits in, where the international competition fits in. Then I think you look at, certainly as you look at the securities industry, you look at how do you create what has come to be known as the firewall, so that risk doesn't spill in? I think the other thing you look at is, how do you make sure that you have regulations, so that from the standpoint of the consumers, everyone is dealing with people that have the same qualifications, that have to adhere to the same regulatory requirements. This is a major frustration to firms in the retail securities industry today. And it is not that the bankers are doing something wrong, it is that the Supreme Court has told the SEC it simply doesn't have that jurisdiction.

Senator GRAHAM. In terms of the customer orientation, which I strongly agree with, there's been some concerns expressed about the fact that in 1927, the banks used their prestige and their name to bring into the securities market people who were timorous and risk averters, but were induced by the magic of the name of the institution to make risk, which proved to be to their detriment, eventually.

If you assume that we, in a capitalist society, have to operate on the assumption that consenting adults can engage in what commercial activities they choose to do so and be held accountable, why wouldn't those consenting adults, which include both individuals and public and private institutions, which utilize the securities industry be better served, if they had a wider range of choices as to where to secure that service?

Mr. **Bachmann**. I don't think that they would be disserved by a wider range of services, as long as the choices are regulated in a consistent manner. Today, as I said, what we run into is FDIC prominently displayed in ads that are selling clearly un-FDIC insured products, and in some cases, situations where there is no insurance. I think what we would look forward to is basically—and I am talking about in the retail securities business—the level playing field.

Senator **Graham**. So you see the issue as not one of the need to restrict banking as a choice of securities customers but rather accepting that as a potentially desirable expansion of opportunity to then assure that that opportunity is equitable, in terms of the competitive circumstances under which it exists; is that right?

Mr. **Bachmann**. We would have no difficulty competing with the banks, as long as we have the same range of services and compete with the same complement of products and services. We are not frightened by fair bank competition.

Mr. **O'Brien**. Senator, may I amplify that just in a small degree. You alluded to the need for opportunity for various services, and I think that's perfectly correct. The fact of the matter is, however, that the availability of the services to the public today is astounding, and only a person who has been around in the securities industry would realize that fact. It is incredible. In fact, the problem today is, in a certain sense, the diversity and the complexity of the services makes choice more challenging than ever before.

The second point I would make is, despite this great opportunity for services, I think consenting adults should be free to do as they wish in the commercial world, perhaps otherwise, too. Suffice it to say that we have a situation where there is, in my judgment, a significant and a major difference between the two industries. The banking business and the securities business, from my experience and judgment, they're different. They have to be treated in a different way. They have to be regulated in a different way, in order that the element of public protection, along with the diversity and opportunity can be provided.

Mr. **Silver**. Senator, if I may, I am glad Ed O'Brien and I aren't up as appointees for judicial posts, but I too believe that consenting adults should be able to do just about anything, but if you recall, and I am sure you do, long before the trade mark law——

Senator **Graham**. I think the chances are, you would have been confirmed by this time. [Laughter.]

Mr. **Silver**. Thank you, sir.

The common law developed the concept, before trademark and copyright statutes, of palming off and even consenting adults may not have palmed off on them through appearance or otherwise, one product when they think they are buying something else. And that's what we really have to prevent here. It is not the question of preventing Ed O'Brien or myself or one of the bankers from getting his banking or securities services from somewhere else, but it's the imprimatur of the bank is the problem. The fact is that banking and securities are two very different kinds of businesses and products. We have got to prevent either the express or the implied palming off of one service for something very different. And the lessons of history, unfortunately, are that that has been very, very difficult to do.

It wasn't done in 1929, it was not done with respect to the REIT's, as recently as the 1970's. Whether that—and the degree it's possible, is your task, and it is not an easy one.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Graham. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman, and I thank you all for being here. I couldn't agree with you more, Mr. Bachmann, about how to make the best use of our time. Once again, Mr. Chairman, we are not talking about the basic goals that we're trying to foster, as it relates to our economy, but are once more we're finding ourselves focused on the narrow turf of powers. Who gets to do what rather than why do we want various institutions to be involved in this. What are we trying to accomplish long term.

All of you in the past have been very eloquent in talking about the need for capital accumulation, the fact that we have markets that people have faith in, will invest in, the liquidity of our marketplace, the fact that that's given us enormous advantages. And it seems to me that that's where we ought to be starting in this debate. That is where we ought to be starting in this discussion, and that is, in part, why Senator Graham and I have picked up on some of the themes that Gerry Corrigan outlined in introducing the legislation that we have introduced.

It seems to me that these are very special institutions. Regulation ought to be consistent in this. There ought to be some way of rationalizing the very, very, different kinds of institutions that we have, which are becoming more and more disparate.

MECHANISM FOR COMBINING REGULATORY PROGRAMS

Shouldn't we, in looking at our financial institutions and what we want them to be, have some kind of a mechanism for pulling together these various regulatory programs? We have suggested in our legislation, that we ought to move toward that kind of a mechanism.

Do you all think that there is a need for doing that, or is the current, I would call it, Balkinization, regulatory framework adequate for doing the job today, and is it going to be adequate in the 21st century?

Let me ask you to start, Mr. Silver.

Mr. SILVER. I guess I said so. I have given an answer before, so in a sense, this may be a soft pitch for me to swing at, but I will give it again. I could come up with instances in the past of inadequacies arising from a Balkanized regulatory system. There has been an integration of products—I can't emphasize that strongly enough—in addition to the integration of the providers of those products. And so even if we were not here today discussing the integration of the providers of those products we would have a problem. I think—and as a matter of fact, in a different life you issued a report that pointed to this last year. Even if we were not talking about the integration of the providers, we would still have a major question before you as to whether the integrated products—it's occurred across all the fences, banking, securities and insurance—whether the present regulatory structures are adequate.

And I don't want to burden the record with examples, but I would just commend anyone to reading your report, if they wanted those examples.

Senator WIRTH. Thank you. We will supply anybody who wants a copy. It was very good. [Laughter.]

Mr. SILVER. So that my answer, of course, to your question, is yes, if we now move on to another level and faced only—not only with integration of products, but integration of providers. The notion under the present system that the SEC can go in an examine books and records to see if there is a net capital violation or whether the investment restrictions of, say, a mutual fund, which appears in the 1940 act, are being violated, and at the same time, a bank examiner comes in, and he looks to see whether the loans to corporations, the commercial lending customers of the affiliated bank are prudent and sound. But without some new methods we cannot find out that this is a bad case. With fragmented regulation, we will know only the mutual fund side, that, yes, there has been compliance with the 1940 act investment restrictions, because they haven't bought too much of the stock of X corporation, while at the same time a bank examiner looking at the bank records, would say, yes, they are not lending too much money to the X corporation, so everything is OK. But there is nobody who will then look to see that the bank is lending money to the X corporation while the securities affiliate, either directly or through the mutual fund, is supporting the X corporation stock.

I am giving you a very homely example on the basic inspection side of regulation.

Senator WIRTH. I understand. It seems to me that there has been an integration of product and of providers. There's an inexorable trend toward Senator Proxmire and Senator Garn are saying, de facto change. Let's admit it there is this inexorable trend, there is this integration, whether we like it or not. That having happened, then what we have to do is put a regulatory framework in place to govern that integration.

We have an integration of products and an integration of providers, but we still have this Balkanized set of regulatory schemes and it doesn't make any sense. Let's admit that there is this integration of providers and products, and to rationalize that, let's do something about these regulatory mechanisms, with the notion of a kind of superregulatory group.

Am I misinterpreting what you're saying, Mr. Silver? You have been a very thoughtful observer of this for a long time, and I respect your analysis and judgment on this.

Mr. SILVER. I fully agree, Senator, that if we march down this road, the kind of approach that you've taken, and because it's new, I think that your present bill really is too limited in what the regulatory council I believe it is or—I remember the term you used—can do. I think that the authority of that group would have to be extended, but your bill does go down that road, and that is a very, very necessary development.

Senator WIRTH. My time has more than expired, Mr. Chairman, but I just want to again make the point that it seems to me that the reflection of what's happened is in the bill that you and Senator Garn have offered. Where we go with all of that is, we would hope, reflected in the bill that we have offered, and it seems to me that there is a lot of room for looking at the way in which these two might fit together.

In any case, I thank you very much. And I thank you, Mr. Chairman.

The CHAIRMAN. Mr. Sasser.

Senator SASSER. Thank you very much, Mr. Chairman.

Gentlemen, a day or two after October 19, Black Monday—I think that was Black Monday—I had the opportunity to be in New York, and I saw some of your colleagues wearing buttons that said "Glass-Steagall Saved Us Again."

Now, Glass-Steagall, of course, as we know, was enacted after the crash in 1929, because there was a perception that the securities activities of the banks had contributed to the financial collapse. That's a perception. I'm not sure that's accurate. But on Black Monday, was Glass-Steagall really a factor in the whole scenario there? In other words—or wasn't it really the Fed's liquidity that came to the rescue? Was there really the idea that there's deposit insurance out there? Just how important is Glass-Steagall in the safety net, in our view? Did it have any function at all on Black Monday?

Mr. BACHMANN. I would like to address that. I think that the fact that you had a securities industry isolated from a banking industry, played a great role. We came so close to disaster, none of us is quite able to comprehend yet, exactly what would have happened, had the market decline continued on into Tuesday. Had it closed at the Tuesday interday low, I am not sure what would have happened, except that it would have been chaos. We were in front—we saw a train racing down the tracks, and those who did try to step in front of it in their securities capacity were just eaten up. The specialists were eaten up, the people who were part of it. In fact, we saw credit being withdrawn from the market at a most critical moment, when fortunately the Fed stepped in and saw to it that the liquidity was there. It was a frightening time, and had the banking system been involved and stepped into that, we can't say where it could have ended. All you needed to do was to be in the midst of that free fall and let it just continue through the end of the day, Tuesday, and you would have, I think, a national crisis.

We did not have. You know, there's a lot of talk about meltdown. We did not have a meltdown. We came close to a meltdown. A meltdown takes place when you go through all buying, and you end up in a complete free fall, where you start triggering things like the liquidation of margin accounts and other things which suddenly fuel the selling beyond what it is.

CONCENTRATION OF SECURITIES INDUSTRY

Senator **Sasser**. Now let me give you the flip side of that, Mr. Bachmann, and that is a defense of Glass-Steagall. Well, now, how do we respond to the charge that the consumers are really not getting what they ought to be getting, that the securities industry is highly concentrated, and that if we let the banks into the securities industry, we'd have more competition and lower prices for consumers of all kinds, and your adversaries will point out that the ten largest firms in the securities industry now have 61 percent of the industry assets versus 48 percent just 5 years ago. And they will point out that four firms have 70 percent of the mortgage-backed securities business. They will point out that five firms have 95 percent of the commercial paper market.

What is the response to that? How do we answer those charges?

Mr. **Bachmann**. I just don't see any lack of competition. Let's just start with commercial paper. If you'd ask how many of those five firms are making meaningful amounts of money with commercial paper, I don't think you are going to find much there. I think the reason you don't have more firms is that there is no profit to speak of in that as an entity. You are talking about very large sums of money, but unfortunately, my firm thought we would try it once, and in one minor area, we wiped out 4 years of profits we decided that there was no future for us in that, but I think you have a highly competitive business today, and I think you see no shortage of competition in any of those areas.

Mr. **Silver**. Senator, if I may. At least in my sector of the business, the mutual fund industry, about 20 to 30 percent of all of our shares are distributed on a no-load basis, and we have very large members who fall into that no-load category. There is no lack of competition.

I might also note that we do have a laboratory experiment in this area, as far as mutual funds are concerned, because one of the endless cases of litigation that we brought concerned the right of the banks to start specialized IRA mutual funds. Now those mutual funds look like every other garden variety mutual fund, except that they are for IRA investors. We lost that lawsuit.

The banks may now sponsor IRA mutual funds. There are about 7 of them at least sponsored by very large banks, and notwithstanding the written testimony of the bankers this morning, in most cases, the fees and charges of those bank-sponsored IRA mutual funds are higher than the competition from our side of the fence.

Mr. **O'Brien**. There is another point to be made too, I think, Senator. If you did have the situation in which banks and securities dealers were together, and I don't know if you were alluding to this or asking a question about it or not, but I doubt that it would have had much of an effect one way or the other on the events of October 19th and 20th. That market was too high, had gone up too quickly, and it was going down. And believe me, there was nothing that could stop it.

Mr. **Downey**. I would like to just add on a little to that, Senator. On the competition issue—and I think you will find it in the appendices to our testimony, that the leading firms in terms of capital have changed, I think, eight times in the last 8 or 10 years. So it is a very, very strong competitive market.

Beyond that, anyone in the United States can get into the securities business except a bank. In fact, I heard the president of First Union say this morning that he would be willing to give up—under a question asked by Senator Riegle—his Federal deposit insurance. If he does that and other banks do that, they're welcome to join the competition. It's very tough. There are choppy waters out there, especially now, but we would welcome that kind of competition. When they bring that Federal safety net with them, that is a whole different kind of competition, one that is impossible to compete with. I know, because I have tried it in the revenue bond business. When they give a put, a letter of credit behind a put, lo and behold, they get to be the underwriter every single time. Just coincidence.

So that is the kind of thing that we can't compete with and I don't think serves the nation well.

Senator **Sasser**. Well, gentlemen, my time is up. Thank you very much.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman. I apologize for not being here this morning, but I was at the welcoming ceremony at the White House, and I will read through this testimony, and I will have some questions at a later time.

The **Chairman**. Very good. Thank you, Senator Hecht.

Mr. O'Brien, as I understand it, you're the president of the Securities Industry Association; is that correct?

Mr. **O'Brien**. That's right, sir.

The **Chairman**. Mr. O'Brien, you heard many questions on your preferences, you and the other witnesses, among the bills before the committee, including the bill Senator Garn and I have introduced. I am now going to give you the opportunity to write your own bill.

Will you provide this committee with the SIA's specific legislative recommendations, by January 1st? I am not talking about a study, not a statement of principles, not those things we should consider. I mean those changes in law that you think we should make prior to the March 1 moratorium.

Mr. **O'Brien**. Yes.

The **Chairman**. If you favor no changes, tell us that, but we want to get a specific recommendation from you.

Mr. **O'Brien**. We will do that.

Without surveying SIA's entire membership, we are not in a position to list all our members who could buy a bank once they qualified and became a bank holding company. Appendix V-A to our written testimony lists all these members of SIA that would be prohibited from purchasing a bank because they are owned by parents that cannot qualify for owning a banking under the Bank Holding Company Act.

An informal survey of our top 25 members who represent approximately 70 percent of the industry's capital and revenues indicates that only two regional broker/dealers may be able to qualify as a bank holding company, and therefore, purchase a bank if S. 1886 is passed.

APPENDIX V-A

Selected SIA Member Firms Wholly Owned by Outside Organizations

- Included below are only those firms where owner is not engaged primarily in the securities industry.
- Shown in parentheses following the firm is its capital rank.
- Where shown, the firm name in parentheses is the parent of the broker-dealer.

Broker-Dealer	Owned By
Angeles Securities Corporation (201)	Angeles Corporation
BLN Investment Corp. (334)	Bankers Life Insurance Company of Nebraska
Blunt Ellis & Loewi Incorporated (58) (Loewi Financial Companies Ltd.)	Kemper Financial Companies, Inc.
Boettcher & Company, Inc. (81) (Beottcher Investment Corp.)	Kemper Financial Companies, Inc.
Calvert Securities Corporation (218) (Claver Group, Ltd)	Acacia Financial Corporation
Citizens and Southern Securities Corporation (253)	Citizens and Southern Corp.
Dean Witter Reynolds Inc. (8)	Sears Roebuck and Co.
Deltec Securities Corporation (205)	Deltec Panamercia S.A.

Source: Securities Industry Association Yearbook, 1987.

Broker-Dealer	Owned By
R. G. Dickinson & Co. (184) (Statesman Group Inc)	Statesman Financial Services
Dillon, Read & Co. (24)	The Travelers Corporation
Donaldson, Lufkin & Jenrette Securities Corporation (12) (Donaldson, Lufkin & Jenrette, Inc.)	The Equitable Life Assurance Society of the U. S.
Eppler Guerin & Turner, Inc. (83) (EGT Financial Corp.)	The Principal Financial Group, Inc.
Federated Securities Corp. (77) (Federated Investors, Inc.)	Aetna Life & Casualty Company
FSC Securities Corporation (N/G)	Mutual Life Insurance Company of New York
W S Griffith & Co Inc (298)	HLI Corp. (Home Life Insurance Corporation)
IDS Securities Corporation (317) (IDS Financial Corporation)	American Express Company
INC Trading Corporation (310)	Instinet Corporation
Janney Montgomery Scott Inc. (48)	Penn Mutual Life Insurance Co.
Kemper Financial Services, Inc. (N/G)	Kemper Financial Companies, Inc.
Kidder, Peabody & Co., Inc.	General Electric Financial Services
Kirkpatrick, Pettis, Smith, Polian Inc. (196)	Mutual of Omaha Insurance Company
Lovett Mitchell Webb & Garrison, Inc. (216) (Gulf Texas Capital Corporation)	Kemper Financial Companies, Inc.

Source: Securities Industry Association Yearbook, 1987.

Broker-Dealer	Owned By
MKI Securities Corp. (87) (MKI Investments, Inc.)	International City Holding PLC
John Nuveen & Co. Incorporated (25)	St. Paul Fire and Marine Insurance Co.
Prescott, Ball & Turben, Inc. (41)	Kemper Financial Companies, Inc.
Prudential-Bache Securities Inc. (7) (Prudential Securities Group Inc.)	The Prudential Insurance Company of America
The Robinson-Humphrey Company, Inc. (66) (Shearson Lehman Brothers, Inc)	American Express Company
Securities Settlement Corporation (57)	The Travelers Corporation
H. B. Shaine & Co., Inc. (259)	DST Systems, Inc. (50%) Pioneer Western Corp. (50%)
Standard & Poors Securities, Inc. (181)	Standard & Poors Corporation
Sutro & Co. Incorporated (165)	John Hancock Freedom Securities, Inc.
Tucker, Anthony & R. L. Day, Inc. (67)	John Hancock Mutual Life Insurance Co.
USLIFE Equity Corporation (240)	USLIFE Corporation
Van Kampen Merritt, Inc. (21)	Xerox Financial Services, Inc.
Wall Street Clearing Company (140)	Barclays de Zoete Wedd Ltd./ Barclays Bank PLC
S. G. Warburg Securities (51)	Mercury International Group plc
The Westcap Corporation (158)	National Western Life Insurance Co.

3064m

Source: Securities Industry Association Yearbook, 1987.

The following SIA members own, or are affiliated with a bank that is grandfathered in CEBA.

Advest, Inc.
Bear Stearns & Co. Inc.
Brown Brothers Harrimon & Co.
Dean Witter Reynolds Inc.
Drexel Burnham Inc.
E. F. Hutton & Company Inc.
Fidelity Brokerage Services Inc.
JJB Hilliard/W.L. Lyons, Inc.
Integrated Resources Equity Corporation
Merrill Lynch, Pierce, Fenner & Smith Inc.
The Ohio Company Inc.
Paine Webber Inc.
Prudential Bache Securities Inc.
Thomson McKinnon Securities Inc.

The CHAIRMAN. Thank you, sir

Now let me ask Mr. Bachmann. Mr. Bachmann, on January 23, 1987, you appeared before this committee. You testified against my proposal to give banks limited securities powers, such as commercial paper, municipal revenue bonds, mortgage-backed securities and mutual funds.

You said then, and I am quoting you now. You said:

> It is possible that the fairer thing is total repeal of Glass-Steagall. Securities firms then could operate fully in the banking business. Total repeal at least would be a two-way solution and not the one-sided repeal being sought by the banks.

Now when S. 1886 offers a full repeal of Glass-Steagall so securities firms can operate fully in the banking business, you oppose the concept.

Why have you changed your position on this issue since last January?

Mr. BACHMANN. I guess I don't feel, Senator, that I have changed it. Those were a choice—those were simply two choices on the horizon. One was the unilateral granting of four powers within basically the same framework we are in today, and the other would be the extreme. I think, clearly, the complete opening up as a two-way street is simply, when you start dividing up the powers, the only one that would seem to enable our members to compete fully. I come back to what I said a little earlier, Senator, that, in my view, we could be setting up a separate framework today to put the banks' securities activities in, to begin the process, to see if the firewall does work, and simultaneously, to determine what does serve the public interest.

I don't think it takes beyond March 1 to get there. And I think that the idea that you put a tough deadline there makes all the sense in the world.

The CHAIRMAN. I have just given another deadline of January 1 for you gentlemen to submit to us your recommendations, and it would be very helpful.

Mr. BACHMANN. Right.

Mr. SILVER. Mr. O'Brien was the president of the SIA. [Laughter.]

The CHAIRMAN. Well, we honor our ex-presidents sometimes more than our present ones. [Laughter.]

Mr. O'BRIEN. Well, I may take early retirement. [Laughter.]

The CHAIRMAN. Mr. Silver, somehow I get the idea you simply don't want banks competing in the mutual fund business under any circumstances. The last time you testified, you argued:

> It would be unfair to let bank holding companies engage in limited securities activities, because Glass-Steagall prohibitions underwriting long-term corporate debt and equity securities would prevent most securities firms from acquiring a bank.

Now that the bill that Senator Garn and I are introducing removes that problem, you argue that it is still unfair, unless we repeal all the restrictions on branching and on engaging in other activities as contained in the McFadden Act and the Bank Holding Company Act.

I sometimes get the feeling that we are shooting at a kind of a moving target.

In any event, why should the quest for the ever-elusive level playing field dominate our decision, if we can take care of safety and soundness considerations and conflicts of interest, why shouldn't Congress repeal Glass-Steagall?

Mr. **Silver**. Well, I think you have gotten down to the fundamentals, Senator. I would just say that in my earlier testimony, I did also raise the McFadden issue as being critical to the existence of a two-way street. And it also raises a separate policy issue. We hear all the talk this morning about bank profitability, justifying repeal of Glass-Steagall. We have a legal situation in which we have a bank in Chicago which can build a tower a thousand feet tall or two thousand feet tall or three thousand feet tall, if it so desires, but it can't branch more than 500 feet from its main office. And as Mr. Seidman pointed out, why should the people of the United States ultimately, through the full faith and credit of the United States which stands in back of FDIC, tolerate that kind of situation? If banks want to compete, wouldn't the first step be to let them compete with each other?

If we are to compete with banks, let us use the genius of the securities industry, which has been to set up national organizations, to compete with the banks head to head in banking as well as securities across the country. It really will do most of Mr. O'Brien's members very, very little good to have a bank in one State and yet in State after State, having to face competition from the large indigenous banks in those States in the full range of their securities activities.

The securities business, the insurance business, are national industries. That is the way they have developed. So McFadden is an indispensable part of the competitive picture.

The **Chairman**. Senator Garn.

Senator **Garn**. Gentlemen, we discussed earlier at great length the two-way street, and it is certainly true, as I mentioned earlier, that the Bank Holding Company Act would still apply to prevent some securities firms affiliated with insurance or commercial firms from buying banks. Now that is true, and I don't dispute that and said I would like to have that broadened, but it ignores two facts, I think. First, most securities firms do not engage in these other types of activities and, therefore, would be able to buy banks.

Second, most of the securities firms that could not buy banks already own them. Of the top ten, nine of them already have them available.

Mr. Bachmann, isn't it true that most securities firms, especially the smaller ones—and you have branches all over the country—would not have to give up any current lines of business in order to buy banks?

Mr. **Bachmann**. I think that—in terms of numbers, I think that is correct. I think, in terms of the amount of the securities businesses, S. 1886 would eliminate many firms—not just the large New York ones, but for example, Loeur and Co., Blunt, Ellis & Loewi, which is in Milwaukee, that is part of the Kemper organization, as are a number of other regional securities firms. Eppler, Geurin & Turner in Dallas is now with the Principal Group. As you go through the list, you find that in terms of not only national but regional representation, that it would disqualify a significant portion of the business, as measured by revenue or measured by capital or measured by those considerations.

And our concern is, if, in fact—let's say the ten largest banks are automatically qualified. In our industry, the large organizations aren't. I am not certain that what I say is correct, so correct me, if I am wrong, but if large investment bankers were engaged in the merchant banking type activities, they could well be disqualified too.

I don't know how your legislation deals with that, but it would appear that it is going to be difficult for a large portion of our membership to gain equal footing.

Senator GARN. Well, you have already testified that the legislation would not preclude most of the smaller institutions from buying banks, and nine out of ten of the largest firms who control most of the securities business in this country already own federally insured nonbank banks. Let me ask you this: What activities would your particular securities firm have to give up in order to buy banks under the Proxmire-Garn bill?

Mr. BACHMANN. That I am simply not sufficiently acquainted with.

Senator GARN. Well, my guess would be that your particular firm would qualify. From my looking at it, I would doubt you would be precluded.

Mr. BACHMANN. My quick reaction is that it probably would, although it might be more attractive for us to become a bank. I don't know the answer to that, except, we would certainly have to explore it.

Senator GARN. Mr. O'Brien, you have attached an exhibit to your testimony, a sampling of the securities firms that could not buy banks, because of their affiliations with other companies. Could you also furnish a list to this committee of all the securities firms that do not have affiliations that would prevent them from buying banks?

Mr. O'BRIEN. Yes, Senator, I will.

Senator GARN. And what I am talking about here is under the provisions of the Proxmire-Garn bill.

Mr. O'BRIEN. Some of those will be difficult to find, because smaller companies that are not publicly held at time are engaged in some of those activities. I think we can come close, but——

Senator GARN. We do not expect perfection. The best job that you can do in supplying both sides of that question.

Mr. O'BRIEN. We will do that.

Senator GARN. Also, if you could, Mr. O'Brien, provide a list of all the securities firms that are affiliated with nonbank banks. We are aware—we have talked a great deal of the nine out of the 10 biggest, but it would be interesting if you could supply us with the complete list as well.

Mr. O'BRIEN. OK. Yes, sir.

[See p. 504]

Senator GARN. So you can't take early retirement. We are giving you so much work that they will have to keep you on. [Laughter.]

Mr. O'BRIEN. I may just want to, Senator. [Laughter.]

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Mr. Bachmann, let me ask you, apart from this great sweeping epic discussion that we are having and great change that some have proposed here.

BANKS AND LIMITED SECURITIES ACTIVITIES

Suppose we just talk about a minimum of change. Suppose we only talked about the issue of banks being able to sell commercial paper. If that is all it was, would that really keep you and the other people in the SIA awake at night? I mean, isn't it——

Mr. BACHMANN. Very quickly, the answer is no, it wouldn't keep us awake at night, but we feel like a dog who's getting its tail chopped off an inch at a time. And it doesn't get any longer. It only gets shorter, and eventually there's not going to be any tail left.

Senator RIEGLE. But to come back to the proposition that Senator Proxmire has advanced previously, it seems to me, as you go through those slices—and I don't know that I want to stick with your tail of the dog analogy [laughter] whether we should go with salami or something else——

Mr. BACHMANN. Salami is the one we have used mostly. [Laughter.]

Senator RIEGLE. At some point, these incremental steps sort of leave one category and go into another category, and they go into another category, and you can certainly talk about securities underwriting, I think, in its full-blown dimensions differently than you can talk about commercial paper. I think those are different things. They don't make the case for necessarily doing it, but I think those are different. I think if you talk about going on and breaching the Bank Holding Company Act and putting banking into commercial activity full-blown, that's clearly another big segmental type step.

But I am wondering, when you come back to the old debate, the debate that has now been superseded by today's discussion, when you take things like commercial paper, mortgage-backed securities, revenue bonds, it seems to me when you get to mutual funds, you know, that may very well be in another segment. I think a lot of people would argue whether it is or isn't.

Let's, for the moment, say it is, and let's just say we're talking about commercial paper, mortgage-backed securities, and revenue bonds. If banks were to be in those activities and only those securities activities for the next 20 years, does that—if the law could be adjusted that way, does that really pose a huge jeopardy to the viability of the securities industry as we think about it, in your view?

Mr. BACHMANN. I suppose if—two "ifs." One if is, if we had equal regulation, if those were treated under equal—and if the securities activities in general——

Senator RIEGLE. Absolutely.

Mr. BACHMANN [continuing]. Such as. And if, in fact, for the next 20 years, that was as far as it went.

Senator RIEGLE. So I take it, that the—not that you want to do that, but the real fear that you have that underlies a step like that, would be that it would just be the beginning of a whole series of additional things, and also the fact that there might be unequal regulation. Is that right?

Mr. **Bachmann**. I think that is at the heart of it. It's an erosion—and so much of this is in the eye of the beholder. This is the problem that we have. I have to look at it from the securities industry's and from my own firm's standpoint. What could be more myopic? The bankers have to represent their standpoint, and what we need is a broader view that transcends.

Mr. **Downey**. Can I answer this one?

Senator **Riegle**. Yes.

Mr. **Downey**. I think that the key thing, Senator, would be the firewall. Would it be a serious firewall? I mean, the examples—you can see it in our testimony—of the overlap, the congruence of an underwriter and a bank. It can be an underwriter and still be in the bank, which gives letters of credit and that sort of thing. That is an impossible kind of competition. Maybe you could separate them. You know, commercial paper isn't a very profitable business, so perhaps that's theoretically possible. But mortgage-backed and revenue bonds are something where the tie-ins, or the potential for tie-ins are rampant. So if you could put those kind of things in a firewall, where you couldn't both be an underwriter and give a loan or a letter of credit on the same transaction, or some kind of restriction like that, I think we could compete with that. We would rather not have it, but we could compete with that, and then that could be the model to see if there were abuses. Give it a year or so. Then come back and look at other things.

And therefore, you might have created a comprehensive model right at the start.

Senator **Riegle**. Now if you were going to do that, if you are going to do that along the lines of what Senator Proxmire suggested, I take it that would have to be a separate affiliate, and I gather you are also saying there ought to be different names. In other words, they ought not—the bank ought not to take a ride off its basic name with the Federal Deposit Insurance link. That it ought to be called something other than that name.

Mr. **O'Brien**. That is correct. There should be some distinction.

Senator **Riegle**. Do you feel that strongly about the name issue or not?

Mr. **O'Brien**. Yes, because otherwise you are not achieving equality of competition.

Senator **Riegle**. But you are saying that if it were truly limited to those kinds of things in a separate affiliate, where would you stand on——

Mr. **Downey**. The existing securities should go in there as well.

Senator **Riegle**. I know, you make that point in your testimony. How would you feel about the mutual fund issue? I know how Mr. Silver feels about it, but let me ask you.

Mr. **Downey**. Well, we—go ahead, John.

Mr. **Bachmann**. I don't know how much mutual funds Goldman, Sachs sells. We sell a lot. [Laughter.]

Mr. **Downey**. I'd rather you don't be in revenue bonds——

Mr. **Bachmann**. I understand.

Mr. **Downey**. But I mean, if you were in that, you'd certainly probably want to test that out, before you got to mutual funds and see if the abuses that have clearly been there before were to continue with this firewall. In other words, Congress could have done firewalls in 1933, and they chose not to, because of the human nature thing that John Bachmann has talked about. Maybe today the firewalls can be done, but you can't just determine on day one that the firewalls will work. You've got to see how they work. Seeing how they work on commercial paper would be a good example.

Mr. BACHMANN. Along those lines, I think—gosh, I hate to be putting words in people's mouth, but Mr. Weatherstone with Morgan Guaranty testified before Chairman Volcker this past February. They have, I believe, set up a separate sub. He talked about the value, and why they went ahead and did it. It was because there is a learning curve. You know, you don't get there just simply by putting it on paper. There is a process involved, and of course, they get up pretty early in the morning, so they were already up that learning curve, while perhaps some others hadn't even thought about it.

Mr. SILVER. Senator, as one candidate in what seems to be a crowded lifeboat at the moment, let me just say, I would go back to our basic case. I think that our basic case about what happened with respect to bank-connected mutual funds before the crash, does not logically make mutual funds a candidate for this kind of experiment.

Senator RIEGLE. So that is where you would draw the line. You obviously have a self-interest there, and I don't mean to delay this, I mean, and it is apparent on its face, because you are here representing that industry, but you are saying in your mind you see where these lines are drawn, that you sort of draw the line between these other kinds of activities and moving on into the mutual funds, and then on into direct securities underwriting, as such, I take it. Is that right?

Mr. SILVER. I would defer to my colleagues as to what the ranking should be, but simply, as I say, looking at the objective evidence of the past, mutual funds pretty clearly fall within the heartland of problems associated with corporate underwriting.

Mr. BACHMANN. I think, on that point, you know, there are two aspects. There's the management of the funds, but there's also the distribution. In the world I am a part of, the distribution has been taking place for some time over the counter in the banks. Now, not in national banks, but in many State banks, because there's been a continuous granting of powers, and herein lies much of our frustration.

Mr. SILVER. One could rationalize drawing that line, Senator, because you do have—if you are going to implicitly or explicitly, confirm the Supreme Court's opinion with respect to bank brokerage activities, I would have to say, as a logical matter, one could also make the distinction between management of funds and the retail sales activity, since retail mutual fund sales are akin to retail stock brokerage activity.

The CHAIRMAN. Gentlemen, thank you very, very much. This is a highly controversial issue you are discussing, and you—I think you've done a fine job. Thank you very much.

The committee will stand in recess until tomorrow at 10 o'clock.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

Statement
of
Charles Pistor
on behalf of
The American Bankers Association

December 3, 1987

I. Introduction

Mr. Chairman and Members of the Committee, I am Charles Pistor, Chairman and Chief Executive Officer of First RepublicBank of Dallas, and President of the American Bankers Association. As you may be aware, the combined assets of our Association's members comprise about 95 percent of the commercial banking industry. While our members range in size from the smallest to the very largest banks, some 85 percent of our members have assets of less than $100 million.

We commend you, Mr. Chairman, and your Committee colleagues for the close attention you are giving to the issue that is the subject of these hearings. It could not be more important or more timely.

At the outset, Mr. Chairman, a word must be said about the Moratorium -- which uniquely applies only to banks. It should lapse on March 1, 1988, as the law provides and as the Congress promised it would. It should lapse whether or not new legislation has been finally produced by March 1, but it is surely our hope that industry, regulatory, and other important constituency inputs will make possible the modernization legislation which is so keenly needed. The reasons for our opposition to the Moratorium are set forth in detail beginning on page 37 of this statement.

Each member of the Committee has a copy of Exhibit 1 -- an important two-page summary of the consumer and public benefits of bank entry into the securities business. You will note that it reviews two areas of particular interest to Members of Congress -- consumer benefits and the enhancement of financial stability which would result from a safe and deliberate reform of Glass-Steagall.

There is little doubt that bank entry into new financial service activities would be beneficial to consumers. In the securities area particularly, the public and consumer benefits of permitting banks to affiliate with the securities firms have been extensively documented by impartial parties outside of banking as well as through detailed industry studies.

Legislative decisions should not of course be based on a choice between competing industry groups, but rather should be based on enabling constituents to enjoy the benefits of greater financial stability and improved financial services at lower cost. Said another way, laws may insulate and protect industries from beneficial competition, or they can open the way for lower prices and improved services for your constituents.

When the well-being of your constituents, and our customers, is made the first priority, certain previously cloudy issues become starkly clear.

If the Glass-Steagall Act were amended to permit bank competition, the result would be substantial local government, business, and consumer savings.

For example, state and local governments, and therefore the taxpayers, could save almost $500 million per year in borrowing costs, according to estimates based on National Governors Association figures, if banking organizations were permitted to underwrite municipal revenue bonds.

Businesses could obtain funds at lower costs as a result of reduced underwriting spreads, if banking organizations were permitted to underwrite commercial paper. Banks are uniquely qualified to extend the benefits of commercial paper borrowing to smaller companies that do not now have access to Wall Street.

Homebuyers could save thousands of dollars in home financing costs according to the National Association of Homebuilders, if banking organizations were permitted to underwrite mortgage-backed securities.

Small investors could increase their savings and investment returns, if banking organizations could sponsor and distributed mutual funds. Not only would bank mutual funds insure that consumers would have more of their investment working for them, but bankers can offer expertise in managing unique portfolios.

Finally, the absence of full and knowledgeable competition in securities activities has produced striking concentrations in that industry where the five largest firms in each market control 95 percent of the commercial paper market, 81 percent of the mortgage and asset-backed securities underwriting market, and 72 percent of the corporate debt underwriting market. It is our opinion that such concentrations are prima facie evidence that the public can be benefitted by other qualified service providers, namely commercial banks.

Mr. Chairman, the consumer benefits of Glass-Steagall reform are explained in detail beginning on page 6 of this statement. In addition to providing these consumer benefits, Glass-Steagall reform would improve financial market strength and stability.

The securities markets would be better capitalized, have more participants, and be more stable, if banks were permitted to affiliate with securities firms and introduce healthy new competition.

The banking industry is the backbone of the U.S. financial system. The events of late October made this quite clear. It was the banking system that the Federal Reserve used to provide the liquidity to stabilize the markets.

But banks are expected to perform this type of function. In fact, the expectation that the banking system will serve as the backbone of our financial system is so fundamental it is taken for granted.

But it should not be. The U.S. banking industry is weakening. The ability of banks to meet their charter responsibilities is declining, and this should be of concern to all.

Exhibit 2 shows this fact. It depicts bank return on equity, the principal measurement for financial performance. Note that this chart excludes the money center banks with LDC debt and those banks with significant agricultural and energy-lending problems. This chart reflects what is happening to banks that are generally regarded as the healthiest.

It is clear that the trend line is down. The return on equity of the "problem-free" banks is declining. The implications of this trend for the long-term soundness of the U.S. financial system are not good. If long-term stability is to be assured, this downward trend must be corrected. It is essential to have a banking system with strong capital, but capital cannot be raised unless an adequate return is expected to be earned on that capital.

The reasons for the decline in bank profitability are numerous. Computer, telecommunication, and capital market innovations are rapidly resulting in a whole range of new financial services. These new services are substitutes, in many cases superior substitutes, for traditional bank products. Normally in our economy, businesses adjust to such innovations by offering the new services, but banks cannot adjust because out-of-date laws prevent banks from expanding to meet new and developing market needs. We cannot offer the services our customers demand; even where we can offer some of the services, we are likely to lose at first, a part -- and then later, the customer's entire business because we cannot consistently offer a complete product line. The result is predictable -- loss of customers and hence loss of profit.

The traditional "nuts-and-bolts" business of banking is changing dramatically, such as in the new technology of asset securitization, whereby even automobile loans, mortgages and credit cards are not held by the originating banks but securitized into the public market place.

Banking must be able to expand and diversify to offset these changes -- yet who could have even defined securitization as a bank technology a few years ago.

The situation is worsened by the fact that many non-bank financial firms are competing with product offerings containing services banks cannot lawfully provide. Some of these products have been astonishingly successful. The number of Merrill Lynch "Cash Management Accounts", for example, has grown in 10 years from zero to 1.3 million containing $160 billion in customer deposit and investment funds -- that's more than the total assets of any U.S. bank!

Merrill Lynch is also going after the mainstay of the community bank customer base -- the good small business customer. It is offering a "Working Capital Management Account" that allows small companies to integrate their cash management, checking, borrowing, and investment activities in a single account. Over nine thousand small businesses have opened them already.

Merrill Lynch is but one example. The list of financial service firms offering product groupings that banks cannot compete with because of out-of-date laws is long indeed. It includes, among others, retailers, auto companies, insurance companies, and securities firms. Just as an example, Exhibit 3 lists U.S. securities firms with bank affiliates. Exhibit 4 lists major foreign banks with U.S. securities subsidiaries. Note that some of the major opponents of Glass-Steagall reform, such as First Boston and Goldman Sachs, in fact have major portions of their stock owned by foreign commercial banks.

In the process of considering changes in Glass-Steagall, the Congress is rightfully concerned about the safety and soundness of our banking system. First, let me say the greatest threat to a sound banking system is to continue the present statutory straitjackets which deny banks competitive opportunities and diminish profitability.

Second, as a proper condition to the new securities activities, our association endorses the introduction of appropriate regulatory safeguards where needed -- to insure "firewalls" between the bank and its securities affiliate and the continued protection of the insured deposit funds. The Comptroller also has proposed steps to strengthen the examination force. We support the Comptroller's proposals for improved examiner compensation.

Mr. Chairman, the benefits of broadened service opportunities for banking organizations is not limited to securities activities. I have taken the liberty to outline the consumer benefits of broadened insurance and real estate activities also. This discussion can be found on pages 20 through 27 of my written statement.

Our industry is not asking Congress for restrictions on banking's competitors; we support an ultimate solution which permits all participants in the financial services industry to compete equally and which encompasses equivalent regulation.

Mr. Chairman, banks of all sizes are asking for the ability to compete -- the money-centers, the regionals, and the more than 10,000 community bank members of the ABA. All are telling us they support the franchise enhancement for banks to participate fully in securities activities. Specific products may be defined today, but, at the rate change is taking place, they may well be obsolete tomorrow. The best approach therefore, as Chairman Greenspan testified, is a comprehensive one which will permit banking institutions to offer all securities services, as the changing market demands.

We believe that the status quo is unfair, unwise, and unreal in the dynamic marketplace. For the sake of a strong, competitive financial system and for the benefit of your constituents, our customers, we urge the committee to take a first step toward modernizing our banking laws by removing Glass-Steagall restrictions on bank securities activities.

II. BENEFITS OF GLASS-STEAGALL REPEAL -- CONSTITUENTS AND CUSTOMERS

The Glass-Steagall Act, passed in 1933, imposed sweeping restrictions on the securities activities of commercial banks. Within two years after its passage, however, its principal architect -- Senator Glass -- had changed his views on the issue of bank securities activities. In a debate on the Senate floor on H.R. 7617, Senator Glass spoke in favor of a provision that would allow commercial banks to underwrite corporate securities. Senator Glass stated that supervision of bank underwriting activities by Federal authorities would provide a sufficient guarantee that the earlier abuses would not be repeated.

Some have argued that the purpose of Glass-Steagall was to safeguard the banking system by separating commercial and investment banking functions. In today's financial markets, however, the actual affect of the Glass-Steagall Act is becoming increasing injurious. It is becoming clear that the consequence of fencing the banking industry off from important growth markets is increased industry risk and a weaker financial system. As financial consumers substitute non-bank products for traditional bank services, the role of banking will shrink, making the bank regulatory system designed to protect the economy less effective. A weaker banking industry also poses serious problems for both the federal deposit insurance fund and for uninsured depositors and creditors. The casualties resulting from a shrinking banking system would impose unnecessary costs on the economy both in direct losses and indirect disruptions.

The relentless pressures of improving technology and changing customer demands have altered the fundamental nature of financial service markets in ways that clearly were not anticipated by the Act's authors. In fact, there is considerable evidence that the Glass-Steagall restrictions on bank participation in important financial markets is shortchanging both the consumers of financial services and the economy as a whole. Repeal of Glass-Steagall would increase competition among financial service providers and encourage innovation, leading to more and better products at lower prices.

Mutual Fund Sponsorship

Many of the 22 million households which own mutual fund shares are paying unnecessarily high sales charges and administrative fees for their mutual fund investments. For example, many mutual funds impose sales charges or "loads" up to 8.5 percent of the amount invested. This means that for a $100 expenditure, only $91.50 is actually invested. In the aggregate, sales charges cost consumers some $3 to $6.3 billion during the first six months of 1987 alone.

In addition to the sales fees, almost one half of the 385 mutual funds surveyed by Business Week imposed administrative fees greater than 1 percent of total fund assets -- most banks charge less than 1 percent for comparable services.

Available evidence suggests that the costs of mutual fund marketing and administration would be scaled back if banks could compete. For example, bank trust departments provide more customer services at lower fees than do mutual funds. And the superior investment performance of bank-managed common trust funds in comparison to mutual funds indicates that bank sponsored mutual funds would very likely provide consumers with higher investment returns.

The existing network of banks and branches -- 56,000 office locations across the country -- provides an ideal distribution system which would increase consumer convenience, decrease distribution costs and make mutual funds available to a wider market by reaching people who are reluctant to deal with investment companies or brokers.

A 1987 survey conducted by Market Facts, Inc., indicates that many households would like to buy mutual funds from banks. The survey found that 40 percent of households identified as "potential prospects", i.e., those expressing an interest in purchasing mutual fund shares within the next six months, would prefer to buy from a bank or thrift. These potential prospects tended to be moderate income, conservative investors who prefer face to face contact when making important savings and investment decisions.

Mortgage and Asset-Backed Security Underwriting

Securities markets are becoming an increasingly important source of funding for loans which have traditionally been originated and held by banks. The securitization process, which transforms illiquid individual loans into salable securities, lowers borrowing costs for two reasons: first, the intermediation costs of using securities markets are lower than the cost of bank intermediation; and second, debt securities tap a much larger pool of funds suppliers than do loan instruments.

The market for privately issued mortgage and asset-backed securities is dominated by three large investment banking firms. In 1986, 70 percent of the dollar volume of mortgage and asset-backed securities was controlled by First Boston, Salomon Brothers and Merrill Lynch. Allowing banks to compete in underwriting all mortgage and asset-backed securities would significantly increase the number of participants in the market, leading to lower underwriting fees. Equally important, bank participation would increase the liquidity of the market for mortgage and asset-backed securities and improve access to capital markets for holders of small loans.

The National Association of Home Builders (NAHB) has estimated that allowing banks to underwrite private mortgage-backed securities might reduce mortgage interest rates by 5-15 basis points. This decrease in borrowing costs would have a substantial impact on the total cost of buying a home. For example, the NAHB indicated that bank participation could save consumers as much as $1,000 on a $100,000 mortgage loan. The reduction in interest rates and monthly payments also lowers the income necessary to qualify for a mortgage loan making home ownership possible for many more families.

In addition to these direct benefits to homebuyers, there are also significant benefits to the economy. For example, according to the National Association of Realtors, a quarter point reduction in mortgage interest rates could result in as many as 30,000 new housing starts each year. The Association further estimates that the increase in construction activity would generate up to 52,000 jobs and $975 million in wages. And the overall increase in economic activity would produce several hundred million dollars annually in additional tax revenue.

While the dollar volume of private mortgage-backed securities is currently small, the potential market is very large. Because the private market has more flexibility, it can respond to a variety of market opportunities and can create securities designed to appeal to a wide range of investors. For example, collateralized mortgage obligations (CMOs) with floating rates have been very popular with foreign investors. This instrument has significantly increased the number of potential buyers of mortgage-backed securities and has opened foreign capital markets to U.S. homebuyers. Innovations like these which expand the potential market for mortgage and other asset-backed securities increase the liquidity of the underlying loans, making them less expensive and more available.

A parallel trend toward securitization is underway in other important bank lending markets. For example, there are over $10 billion in securities backed by auto loans and over $600 million in securities backed by credit card receivables outstanding. Securities have also been issued backed by lease receivables and commercial real estate. The potential market for asset-backed securities is large. The total dollar volume of auto loans outstanding is over $245 billion, and consumer revolving credit exceeds $135 billion. Bank participation in the securitization of these types of loans can be expected to provide the same benefits of improved access to funding and lower costs to borrowers as mortgage-backed securities provide to mortgage customers.

Municipal Revenue Bond Underwriting

If banks were permitted to underwrite and distribute revenue bonds, state and local borrowing costs would be reduced.

Municipal government experts estimate that bank participation could save revenue bond issuers as much as $5 per $1,000 of borrowed funds. Based on the $96.5 billion in municipal revenue bonds issued in 1986, the savings in underwriting fees could have been as high as $480 million for state and local governments.

Allowing banks to underwrite revenue bonds would also help to reduce the issuer's costs by increasing the pool of potential investors and by adding liquidity to the secondary market. Banks have contact with customers who might otherwise not be exposed to revenue bond issues; to the extent that banks can cheaply and efficiently reach these potential new investors, the interest rate issuers must pay to attract buyers will be reduced. This ability to reach new markets is particularly important in the municipal bond market which is extremely fragmented and decentralized, making information costs unusually high. Allowing banks to underwrite and distribute a full line of municipal revenue bonds would improve the flow of information from issuers to potential buyers, thus reducing the interest rates issuers must pay.

Since small bond issues do not attract regional or national attention, and since investment banks do not have a local presence and customer contact in small communities, banks are the natural underwriters for small municipalities. Expanding the banking industry's authority to underwrite a full line of revenue bonds will give small municipalities a better opportunity to use revenue bonds as a financial tool to meet community needs and will enable communities to provide more and better local services at a lower cost to taxpayers.

Because they recognize the potential for substantial cost savings and improved market access, all the major organizations of state and local governments -- the National Governors Association, National Conference of State Legislators, National League of Cities, National Association of Counties, U.S. Conference of Mayors, and Government Finance Officers Association -- support authorizing banks to underwrite and deal in municipal revenue bonds. Moreover, 13 states have passed laws allowing their state-chartered banks to underwrite revenue bonds.

The question of whether to allow banks to underwrite and distribute revenue bonds has recently taken on added importance as several large underwriters, including Salomon Brothers and Kidder Peabody, have announced plans to withdraw from or reduce their commitment to the municipal market. In 1986, Salomon Brothers was the second largest underwriter of municipal issues, handling a dollar volume in excess of $13.5 billion of municipal bonds. Together, Salomon Brothers and Kidder Peabody accounted for 11.5 percent of total 1986 underwritings.

The contraction in the number of significant market participants will result in further concentration in the municipal securities market. Clearly, new entrants into the municipal revenue bond market would benefit issuers by increasing competition, improving access to the market, and reducing underwriting costs.

Commercial Paper Underwriting

Five securities firms -- Merrill Lynch, Goldman-Sachs, Shearson-Lehman Brothers, First Boston, and Salomon Brothers -- control an estimated 95 percent of the market for dealer-placed commercial paper. At these levels of concentration, increasing competition by permitting banks to underwrite and distribute commercial paper can be expected to result in reduced underwriting costs, lower interest rates, and improved service to issuers.

U. S. banks have more experience than any other financial institution in making business loans and providing letters of credit that back commercial paper. The banking industry also has the most extensive knowledge of local lending markets and expertise in evaluating the financial condition of their own business borrowers. These skills make banks especially well suited to extend the benefits of commercial paper borrowing to include those smaller companies which would be unlikely to have access through the large New York investment banking firms which currently dominate the market. Lower borrowing costs for these smaller companies may stimulate investment, leading to more jobs, increased output and lower consumer prices.

The volume of commercial paper has grown dramatically during the past decade in response to two basic changes in financial markets. First, improvements in technology have increased the availability and reduced the cost of financial information; and second, the emergence of important new institutions such as money market funds has created a huge market for short-term paper. These market forces, in combination with the relatively high costs of bank intermediation, (including regulatory capital requirements, non-interest bearing reserve requirements and deposit insurance premiums), make bank loans a more expensive source of funds vis-a-vis the issuance of commercial paper for some borrowers.

So far, the increased use of commercial paper has come primarily at the expense of large bank commercial loans. The impact on this market has been dramatic. See Exhibit 5. In 1966, commercial lending at large banks accounted for more than 86 percent of the short-term credit of domestic non-financial corporations. By 1975, the share was about 71 percent; and in 1986, it had fallen to 54 percent. As the commercial paper market becomes accessible to smaller corporations, community and regional banks may also begin to lose many of their most creditworthy business customers.

The continuing loss of prime business borrowers leaves banks with an increasingly risky customer base and lower quality loan portfolios. The inevitable consequence of the increased industry risk is higher funding costs leading to higher fees and loan interest rates for bank customers. Allowing banks to underwrite commercial paper offers an opportunity to reduce their operating risk by earning fee income and by retaining valuable customer relationships. This, in turn, will enable banks to continue to provide all their customers, including consumers and small businesses, with efficient, low cost services.

Corporate Securities Underwriting

While there are many firms which underwrite corporate securities, the market is dominated by a handful of large investment banks. In 1986, the top five corporate underwriters handled over 65 percent of the dollar volume of securities issued. Five firms accounted for over 72 percent of the nonconvertible debt issued in 1986. New entrants into the corporate securities market would clearly be beneficial to issuers. Allowing banking organizations to participate would decrease concentration; for example, in the Eurobond market where banks can compete, the top five underwriters accounted for only 35 percent of the market.

There is evidence that increased competition will lead to lower fees. For example, in 1982 when Japanese banks were permitted to make markets in government securities in the over-the-counter market; bid-ask spreads dropped immediately from 40 to 20 basis points and have remained at approximately that level thereafter. The benefits of increased competition in reducing costs for issuers is also evident closer to home in the municipal bond market. Underwriting fees in the general obligation market where banks can participate are significantly lower than in the revenue bond market where banks currently cannot participate fully. In fact, the National Governor's Association estimated that lack of competition in the revenue bond market may add as much as $5 per $1,000 of par value to the cost of underwriting revenue bonds.

In addition to reduced underwriting fees, bank competition may help corporate issuers by pricing issues closer to their true market value. Studies have shown that corporate underwriters have consistently underpriced new issues. For example, between 1960 and 1982, new equity issues were underpriced by an average of almost 19 percent. This underpricing represents a significant loss of potential revenue for issuers. To the extent that increased competition addresses this chronic underpricing, issuers of corporate securities stand to benefit.

Bank participation in the corporate securities market would be a natural extension of the financial services they currently provide for business borrowers across the country. In particular, smaller firms and first time issuers would enjoy improved access to securities markets. These firms already have a relationship with their bank but are unlikely to have dealt with an investment bank. The recent decline in the number of regional securities firms makes bank participation even more valuable to smaller issuers which do not have access to the large New York investment banks.

III. BENEFITS OF GLASS-STEAGALL REPEAL -- COMMUNITY BANKS

While the use of additional securities products and services by money-centers and regional banks has perhaps received more attention, community banks will also find new opportunities of great value.

With few exceptions, the return on equity of community banks is declining. Community bank (as represented by FDIC-insured commercial banks with assets less than $100 million) return on equity has deteriorated from about twelve percent in 1977 to about six percent last year. The decline stems from rising loan losses, falling net interest margins, and increasing capitalization. The seriousness of these trends is depicted in Exhibit 7, the Community Bank Financial Profile and Exhibit 8, the Community Bank Return on Equity.

The deterioration in community bank asset quality and profitability is due in large part to general economic conditions, especially to problems in the agricultural and energy sectors. An increasingly important dimension of the community bank earnings problem, however, is an inability to diversify loan composition and income sources and to match the product and service offerings of non-bank financial service companies.

Nonbank financial firms are taking community banks' best loan customers, forcing the banks to accept lower asset quality. For example, the low-rate financing introduced by the captive finance company subsidiaries of the big three automobile manufacturers (General Motors, Ford and Chrysler) has cut painfully into community banks' loan business. Commercial banks' share of the automobile financing market fell from 52 percent in 1980 to 41 percent last year. Conversely, the market share of non-bank finance companies, dominated by the auto makers' captive finance companies, rose from 29 percent to over 38 percent over the same period. As community banks continue to lose market share they have been forced to scramble for customers. This is evident in the rise in loan approval and loan delinquency rates. In other words, the pool of good and financially sound loan customers is being drained by the increased competition from non-bank firms such as the finance company captives of the auto manufactures.

Mutual fund shares compete directly with bank deposits and drive up bank funding costs. Securities market innovations are enabling the best commercial bank customers to obtain needed funds at lower cost through investment banks, causing the customer base of commercial banks of all sizes to consist of more risky businesses and households. The adverse effects of these trends are reduced interest margins and higher loan losses for all banks. The impact on community banks, though less direct, may be more serious because of the local economic problems many community bankers are attempting to overcome.

Like their regional and money center colleagues, community bankers are facing increasing competition from non-bank financial firms offering a wide variety of service packages. Securities firms, finance companies, insurance brokers, and others are pulling customers away from community banks with very attractive product offerings that community bankers cannot match because of the restrictions in the Glass-Steagall Act.

WHAT COMMUNITY BANKERS WILL BE ABLE TO DO AFTER GLASS-STEAGALL

Repeal or substantial modification of the Glass-Steagall Act will permit all commercial banks to engage in a wide variety of securities activities now prohibited to them. The costs associated with bank capital, reserve requirements and deposit insurance premiums will encourage banking institutions to shift a significant portion of their lending and deposit taking activities into securities-related forms that are not so encumbered.

The current adverse effects of bank securities activity restrictions will, when those restrictions are removed, be replaced by benefits arising from a substantially increased demand for capital market services of all kinds. Households, businesses, and government entities in individual communities all across the United States are the source of virtually all the assets and liabilities that flow into the capital markets. Because no institution functions at the community level with the effectiveness of community bankers, these bankers will be the foundation on which bank securities activities stand.

It can be expected, then, that community banks will over time become originators and servicers of locally derived loan assets, participants in underwriting local government securities, and mutual fund brokers and distributors. The larger banks -- regional and money center institutions -- can be expected to become the actual underwriters of asset-backed, government, and corporate securities, and the sponsors and managers of mutual funds. As the role of banks in the securities markets and the markets themselves grow, the profit potential for community banks will be substantial, particularly in the areas of loan asset origination and servicing, asset-backed securities underwriting participation, mutual fund marketing and administration, unit investment trust origination and placement, and local government securities underwriting and distribution.

A. Mutual Fund and Unit Investment Trust Marketing and Administration

Surveys show that most people would prefer to invest in mutual funds and unit investment trusts on a face-to-face basis with a local financial institution. This fact makes community banks the most widely dispersed, trusted, and capable system for distributing these investment vehicles in the United States.

The profit enhancement potential in mutual funds and unit investment trusts is probably only just beginning to be tapped by community bankers. Banks already can sponsor mutual funds for investment of IRA assets. As the experience with IRA accounts has shown, customers with inheritance, accumulated savings, bonuses, Keogh accounts, or employee 401(k) accounts are good prospects for mutual fund and unit investment trust products. Even corporate customers have a variety of operating, investment, and pension cash management needs that can be met with mutual funds. The market for mutual fund and unit investment trust shares is large and growing; community bank participation in it is essential.

The Glass-Steagall Act permits banks to perform most routine mutual fund and unit investment trust administration and brokerage functions. However, banks are foreclosed altogether from lucrative sponsorship and distributing activities.

It is likely that very few community banks will choose to actually sponsor -- set up and manage -- their own mutual funds. Sponsorship will be a large regional and money center bank specialty. Community banks will, however, be key participants in the distribution and local administration of bank-sponsored mutual funds. Either alone or in joint ventures with other banks (through service corporations), community banks are expected to provide vitally needed mutual fund distribution, custodial, and administrative services.

On the other hand, community banks may take an active role in sponsoring unit trusts which are based on local real estate, economic projects, or local municipal bonds.

The profits from these activities will consist of sales commissions associated with distributing shares and fees for custodial and accounting services. Sponsorship fees would also be earned if a bank actually sponsors a mutual fund or unit investment trust on its own or in a joint venture with other institutions.

B. Local Government Debt Underwriting and Distribution

Across the United States there are thousands of towns and communities that are dependent on municipal revenue bonds to finance their operations. Roads, sewers, and other municipal improvements of all kinds are financed by such securities. In decades past, state and local governmental activity tended to be financed with bonds that were general obligations of the governmental unit and backed by its taxing authority. As the resistance to state and local tax increases grew, reliance on general obligation (GO) bonds declined, and the use of bonds linked to the revenue streams of specific projects increased dramatically. Such revenue bonds now dominate the municipal market, accounting for over 70 percent of the dollar volume of the securities issued by state and local governments.

Banks are permitted by the Glass-Steagall Act to underwrite general obligation bonds, but because they are now used so infrequently this authority is of less value to community bankers. Because authority to underwrite municipal revenue bonds is not explicitly provided in the Glass-Steagall Act, banks are generally foreclosed from this activity. Underwriting municipal revenue bonds could be a key source of new community bank profits.

Because banks are prohibited from underwriting municipal revenue bonds, there is little local competition in underwriting them, and many towns and communities are forced to pay higher than market rates to finance their operations. It is estimated that this absence of effective competition costs state and local governments $480 million annually.

Community banks are repositories for state and local government funds. Bank officers through the bank's public funds department have long-established relationships with local governmental officials. These relationships can form the foundation for the bank developing underwriting relationships with local and regional governmental units.

Banks are permitted to underwrite GO bonds, and because of this competitive presence the GO underwriting spread is lower than the municipal revenue bond underwriting spread. The GO underwriting spread ranges between 75 and 400 basis points. Even if increased competition from bank participation reduced the revenue bond underwriting spread to, say, 150 basis points, roughly the middle of the GO bond range, a community bank could still substantially increase its net income by underwriting revenue bonds. For example, if a $100 million bank were to underwrite a $10 million revenue bond issue, net income would jump $45,000 and ROE would rise 53 basis points -- a very attractive consideration.

C. Loan Asset Origination and Servicing

The activity that is likely to contribute the most to community bank profitability after the Glass-Steagall restrictions are lifted, ironically, is one they can engage in already -- originating and servicing loans for resale to other institutions. This is now, however, a somewhat limited activity for two reasons. First, the processing technology for securitizing commercial and industrial (C&I) loans is only now reaching maturity. Second, loans cannot be pooled and sold as securities to other banks except under very limited conditions; that would be underwriting, a prohibited activity.

The profit advantage to community banks of selling a loan to an underwriting institution arises from the ability to earn origination and servicing fees and the spread income on the portion of the loan retained in portfolio, while substantially reducing the cost associated with capital adequacy, reserve requirements, deposit insurance, and other regulatory costs. For example, experts in the area of C&I loan securitization estimate that if the profit potentials were fully realized, a participating bank's return on equity could be increased by as much as 600 basis points. (See Sanford Rose, "How to Raise Loan ROE by 600 Basis Points," American Banker, August 25, 1987.)

This estimate may be unrealistically high. Bank entry into securitized C&I loan underwriting will tend to eliminate most of the present market imperfections and drive down the underwriting spreads the experts perceive to be obtainable now. Nevertheless, even if the actual returns are only half or a third of what the experts perceive, an increase in return on equity of 200 or 300 basis points is very attractive.

D. Securities Underwriting and Distribution

It is unlikely that any community banks will become lead underwriters of loan-backed or debt securities. This is, in fact, an activity that requires substantial size to engage in profitably and can be expected to be a capability of only the largest regional and money center banks. This fact, however, does not mean that community banks will not be active, indeed major, participants in the securitization process. Community banks will be the primary originators and servicers of loan assets for underwriting in the securities markets by larger banks. And critically, they will be key components in the process of distributing the resulting asset-backed securities.

Community bankers have unique and valuable relationships with local investors of all kinds -- businesses with cash investment needs, institutions such as pension funds and local governments with short and long term financing needs, and individual investors with significant resources. These local relationships cannot be duplicated by the regional and money center underwriters and will be crucial to successful underwritings in a post-Glass-Steagall environment. As loan securitization expands, the need for local level distribution will be essential and will draw community banks into the underwriting and distribution process itself as syndicate participants.

The securities underwriting business is now quite concentrated. A handful of New York investment banking firms control the lion's share of the market. As an example, the three top underwriting firms control 70% of the mortgage-backed securities underwriting business. It is expected that the enormous profitability of these firms will decline substantially if banks are permitted to compete in asset-backed underwriting. Nevertheless, the access that community banks have to local investment outlets will be essential to successful future bank underwriting efforts, and that unique access will result in improvements in participating community bank equity returns. Those improvements will consist of a share in the underwriting spread for assisting in the distribution of the underwritten securities.

E. Portfolio Management and Diversification

The loan portfolios of community banks are frequently characterized by high concentrations of loans to local enterprises. These concentrations have had a profoundly serious impact on earnings for banks located in agricultural and energy regions. Such concentrations, however, are an integral part of community bank efforts to meet local credit needs.

The Glass-Steagall Act's securities restrictions have hampered the banking industry's development of ways to meet local credit needs without imposing undue loan concentrations on community bankers. Statutory changes that permit banks to participate in the securities market development on both the asset and liability side will do more than just open up significant new earnings possibilities for community banks as described below. The changes will permit community banks to diversify their portfolios among industries and geographical regions. This will reduce the dependence on local economies without diminishing the ability to meet local credit needs.

A community bank would continue to make loans to local customers. These loans would be pooled with loans in other industries and geographic areas and used as collateral to back securities. Purchases of similar loan-backed securities by community banks would be attractive, diversifying investments. Pooling and selling local loans in the form of asset-backed securities would make funds available to the local community for further lending, enhancing community growth and prosperity.

The energy and agricultural sectors of the U.S. economy are now experiencing major adjustments. Other sectors could be similarly affected in the future. The ability to diversify credit risk will enable community banks to strengthen their portfolios and increase their flexibility in asset/liability management. The result will be more efficient use of capital and higher returns on equity.

F. Operational Considerations

Many of the securities activities discussed above would not pose a risk problem even if they were conducted in the bank itself, or in a subsidiary of the bank, rather than in a separate subsidiary of a holding company. For example, distribution of mutual fund shares could be conducted safely by the bank itself. The ability to offer low risk products outside the holding company structure is very important to the 4,500 community banks which are not currently organized as bank holding companies. For these banks and their customers to benefit from legislation expanding their product and service authority, consideration should be given to allowing them to conduct low risk activities without the need to restructure as holding companies.

IV. BENEFITS OF BROADENED INSURANCE AND REAL ESTATE AUTHORITIES

In February 1987 the Consumer Federation of America (CFA) published a massive study on insurance that provides critically important new evidence of the benefits that would accrue to consumers from bank entry into insurance brokerage and underwriting activities. The study is entitled, "The Potential Costs and Benefits of Allowing Banks to Sell Insurance". The study finds that the present life insurance system imposes excess costs on consumers totalling $5-$10 billion.

Insurance Brokerage

The Consumer Federation study reveals that there would be "significant potential policy-owner savings" if banks could more freely engage in life insurance sales.

The Consumer Federation analysts contacted insurance offerers and asked for copies of their policies. The analysts found that "savings banks and brokers based in banks sent policies that were lower in cost." Some agents resisted or refused to provide the requested information. The Consumer Federation study explains why: "...comments from many of these agents reveal that the reason for their reluctance is a fear of competition."

The results of an extensive econometric analysis of the insurance industry that is a key part of the Consumer Federation's overall study reveals that "competition from banks could lower costs industry-wide".

The Consumer Federation also surveyed insurance sales practices nationwide. They found that "banks are more responsive to consumer requests for information" than captive or independent agents. The study specifically states, "To summarize the responses to the survey, every one of the comparisons shows that bank sellers of life insurance were more forthcoming with information than agents... the policies sent by bank-based sellers were much lower in cost. This was true of both savings banks and bank-based brokers."

Other important findings of the Consumer Federation insurance study are:

- "The literature review establishes a clear economic basis on which potential cost savings to consumers might be based."
- "Insurance subsidiaries of financial and non-financial companies have lower operating costs and lower policy-owner costs."

- "The best available direct evidence suggests that competition between different institutions does operate to lower costs to consumers ... there is no clear evidence that bank diversification results in greater concentration."

- "The survey evidence does not indicate a great potential for tying or the existence of a great deal of tying in those areas where banks currently sell insurance."

In its discussion of the policy implications of its findings, the CFA stated that careful regulatory policies to maximize consumer benefits and minimize undesirable practices or results should accompany bank entry into the insurance business. If bank entry was accompanied by rigorous disclosure of key consumer information such as premiums, surrender values, and rates of return, the CFA found bank entry "a particularly positive element to inject into the industry." The ABA has stated that it would be receptive to accepting reasonable disclosure requirements as part of any legislation authorizing bank sale of insurance.

In conclusion, the Consumer Federation study states:

> ... the dilemma facing consumers and policy-makers is that the current regulation and structure of the insurance industry leave a great deal to be desired. Bank entry could not only capture the unique benefits associated with direct bank sale of insurance, it might also drive the industry to perform better as a whole... the potential benefits are large enough for policy-makers to work very hard at striking the proper balance. There is no reason to prohibit states from carefully expanding bank sale of insurance or federal authorities to dismiss bank sale of insurance out of hand.

The Consumer Federation of America is not the only nationwide consumer group that believes bank entry into insurance would benefit consumers. In testimony before the Senate Banking Committee in July 1987, J. Robert Hunter, president of the National Insurance Consumer Organization, said:

> Banks are a logical source of insurance. Sales outlets in banks would be convenient for consumers and should be extremely efficient points for sale. The incredible reaction of insurance agents against bank entry is due in the main to their inefficiency and high cost.

During that same U.S. Senate hearing, Wisconsin's commissioner of banking and New York's superintendents of insurance and banking also supported expanded insurance products and services for banks.

Some major insurance providers are also marketing an array of financial products, including bank products. Travelers Insurance is developing a complete package of retail banking services aimed at the broad American middle class and is testing it through an asset account utilized by customers who authorize direct deposit of their paychecks into Traveler's non-bank bank.

Prudential Insurance, whose television ads tout FDIC insured Certificates of Deposit from its non-bank bank as one "piece of the rock," has announced that it will begin offering MasterCards to its policyholders, emulating an earlier move by John Hancock into the credit card business.

Metropolitan Life controls the nation's largest real estate brokerage network, Century Twenty-One, and has embarked upon an ambitious program to market mortgage credit, in tandem with homeowners and mortgage insurance, to Century Twenty-One's realty customers. In current pilot programs seventy percent of all real estate customers referred to Century Twenty-One insurance agents buy insurance products. And Met Life is planning to build on its initial success by adding mutual funds and annuities to its product mix. Finally, note that in September 1987 the Empire of America Federal Savings Bank announced that it will market a home equity line of credit through the five thousand insurance agents representing the Mutual Life Insurance Company of New York -- MONY.

Combinations of credit, insurance, and other financial services, which insurers allege to be so unconscionable when proposed by the banking industry, are already being actively marketed by major insurance industry players whose customers are not receiving the same Federal protections against tie-ins that are already on the books for bank holding companies.

Insurance Underwriting

Banking and insurance underwriting are very closely related. Both businesses involve the solicitation of funds -- deposits in one case, premiums in the other -- and the investment of those funds in loans or securities. Banks manage their assets and liabilities to meet their depositors' demands; insurance companies manage their assets and liabilities to meet policy holders' claims. In addition, the marketplace evolution is erasing the distinctions between many banking and insurance products. For example, there is no functional difference between a bank's standby letter of credit and an insurance company's financial guarantee. Both institutions compete head to head for this type of business. This existing expertise would make banks valuable competitors in the insurance underwriting market, if they were permitted to participate.

Currently, bank holding companies are authorized to underwrite credit life and credit accident and health insurance that is directly related to an extension of credit. In the past such insurance has been provided in connection with installment loans. Recently, the Federal Reserve Board approved a bank holding company's application to underwrite home mortgage redemption insurance. In reaching its decision, the Board determined that there would be considerable net public benefits from the bank holding company's entry into this market, including the availability of insurance products with a greater variety of features.

Consumers, businesses, and governments would benefit from giving banking organizations the ability to underwrite all types of insurance. While banking's entry into insurance underwriting would probably start slowly and focus on the most predictable risks, allowing banks into the business should make future insurance cycles smoother, thereby stabilizing the overall earnings and performance of participants.

Allowing banks to underwrite insurance would provide a badly needed increase in underwriting capacity in the property/casualty area. The need for additional capacity was amply documented more than a year ago by the property/casualty industry's own non-profit statistical organization. The Insurance Service Office's February 1985 study on "The Coming Capacity Shortage" predicted that the availability of property/casualty insurance would fall short of demand by $62 billion in the 1985-88 time frame. The study's evaluation and recommendations section strongly questioned the continuation of the insurance industry's strident opposition to entry by other financial entities.

The competitive benefits of permitting banking organizations to enter insurance underwriting would improve industry efficiency, resulting in lower costs and improved service for customers. There would be an increase in underwriting capacity which should reduce the likelihood of severe market constrictions, including the outright withdrawal from certain markets by some insurers. This as you know has been an a particular problem in certain lines of officer and director, medical malpractice, and property and casualty insurance.

In addition, permitting the banking industry to underwrite insurance would encourage the innovation of new types of insurance products designed to meet the changing needs of the market. An important example -- the liability insurance crisis of the last few years prompted Florida and Ohio to give state banks the authority to provide reinsurance underwriting.

Tie-In Sales

Perhaps the most frequently used argument against banking organizations offering certain non-banking services is that they have market power that they would exploit in offering such services. Despite unsupported insurance industry assertions, there has never been any evidence presented by that industry that tie-ins of insurance and other products and services, either explicit or implicit, are a common practice.

A 1986 report to the Consumer Advisory Council of the Federal Reserve Board concerning credit insurance obtained on non-mortgage closed-end debt shows that the claims of coercive tie-ins are vastly exaggerated. The results revealed that nearly all borrowers who purchased credit insurance thought that it was a good idea and would do so again in the future. Moreover, the vast majority of borrowers, in excess of 95 percent, felt that their decision to buy insurance had no effect on the creditor's decision to grant the loan regardless of whether or not they had purchased the insurance.

Many safeguards relating to the offering of insurance are and would continue to be imposed on banking organizations alone. For example, the public benefits test contained in Section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843) would continue to apply to all bank holding companies desiring to sell insurance. This requirement provides protection for the public interest that is not also provided by insurance company regulation. In addition to this requirement, bank holding companies are subject to state-imposed insurance regulations, the Truth-in Lending disclosure rules covering the sale of insurance in connection with a credit transaction, and the anti-tying provisions of the antitrust laws and Section 106 (12 U.S.C. Section 1972) (1) of the Bank Holding Company Act Amendments of 1970 (P.L. 91-607), which state:

> A bank shall not in any manner extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration of any of the foregoing, on the condition or requirement
>
> 1) that the customer shall obtain additional credit, property, or service from such bank other than a loan, discount, deposit or trust service;
>
> 2) that the customer shall obtain additional credit, property, or service from a bank holding company of such bank, or from any subsidiary of such bank holding company.

These provisions are applicable to all extension of credit, leases or sales of property of any kind, the furnishing of any service, and the pricing of any of the foregoing. The anti-tying provisions are unusual in banking law in that they both provide the opportunity for enforcement by the federal bank regulatory agencies and also provide a specific private right of action to plaintiffs who may have been injured as a result of tie-in sales. Moreover, Section 106(e) of the existing anti-tying provisions authorizes recovery by plaintiffs of treble damages for any violation, as well as the cost of suit and reasonable attorney's fees. This extraordinary remedy is obviously designed both to deter violations on the part of individual banks and to encourage plaintiffs who may have been harmed by such violations to bring suit for the recovery of damages.

It is instructive to note that the anti-tying provisions that have been in effect for 17 years have been rarely used by plaintiffs. The very paucity of their use indicates that they have been successful in deterring bank tie-in sales even when penetration rates are high. The breadth of the prohibition of tie-ins in the statute ensures that whatever new activity banks may engage in will be subject to these prohibitions. Also, it is a specific responsibility of bank examiners to report any evidence of coercion.

Any attempt to coerce a customer would result in a customer moving to a competitor. It also makes no sense to jeopardize a customer relationship by using coercive practices to increase just one part of the relationship.

Because the insurance industry is also a significant factor in the markets for financial services (e.g., life insurers hold about half of all outstanding corporate bonds), there is the potential for tie-ins in that industry as well. Metropolitan Life Insurance Company's recent purchase of Century 21, the nation's largest real estate sales organization, highlights this fact. While we do not intend to imply that Century 21 engages in any tying arrangements, this acquisition should obviously facilitate the cross-selling of real estate brokerage, mortgage finance and homeowners insurance products.

Certainly, if a consumer is ever to feel implicit pressure to purchase insurance products as a condition of receiving credit, you would expect it to arise in the mortgage finance transaction -- the largest loan that most Americans ever secure. Metropolitan is training insurance agents to work with Century 21. The results of pilot programs show that 75 percent of all those Century 21 customers referred to these agents buy insurance products from them. Metropolitan Life has estimated that in five years it will sell 200,000 homeowner insurance policies a year through Century 21, up from 40,000 a year before the acquisition. Similar attempts to cross-sell loans, insurance, and other financial products and services are being undertaken by Sears, Prudential-Bache, American Express, and even Ford and General Motors. Ford Motor Company owns the seventh-largest interstate thrift institution in the country, First Nationwide, which engages in all insurance activities through its service corporation like many other thrifts.

The banking industry's position on these developments is very simple. If public policymakers want additional consumer protections, then they should be designed to apply to all lenders who sell insurance. Why should banks and bank holding companies be singled out for special treatment?

Real Estate and Banking

With only a few exceptions, banks are prohibited from engaging in real estate development and brokerage activities. Allowing banks to engage in real estate activities would benefit consumers, real estate companies, and banks. Consumers would benefit from lower commission rates that would result from increased competition in the real estate brokerage business. Real estate companies would benefit from a broadened array of financing options. And banks would benefit from the improved income stability that would result from greater operating diversification.

Brokerage Fees

Based on information provided by the Federal Trade Commission, the National Association of Realtors, and the U.S. Department of Housing and Urban Development, consumers paid an estimated $20.3 billion in real estate brokerage fees in 1986. It is not possible to predict precisely how much these fees would decrease if banks were permitted to act as real estate brokers. Nevertheless, the increased competition is likely to have a significant impact. If U.S. bank entry into real estate brokerage reduced fees from the current average of about 6 percent to 4 percent, the estimated savings to U.S. homebuyers would be about $5.3 billion. For buyers of an average existing home ($98,000 average cost) the savings would be $1,575. For new-home purchasers ($112,000 average cost) the savings in brokerage fees would be about $1330.

Real Estate Development

Banks already participate actively in real estate finance through debt investments. Real estate developers and the communities which they help develop would benefit from banking firms being allowed to make equity investments as well.

Developers would benefit in several ways. Financing options would be much more numerous, and the difficulties of obtaining financing would be reduced. The problem of obtaining equity financing from one source and debt financing from another would be lessened. If developers so chose, they would be able to conveniently structure individual projects so as to reduce their leverage without putting up more of their own money. This would allow more flexibility in payments schedules and decrease the probability of a development project having financial problems. In addition, the substantially greater level of competition among suppliers of equity funds would lower development costs.

Communities would benefit from stimulation of real estate development. Equity investment would encourage banks to have a longer-term perspective in real estate investments. This perspective, combined with the lessened burden of fixed payments schedules for principal and interest, would probably dampen the cyclically of real estate markets. Moreover, the reduced risk and lower development cost would mean that projects which might not otherwise have been feasible would be undertaken. Additional and more stable economic and geographic growth would be encouraged.

V. AFFILIATE SEPARABILITY -- PUBLIC POLICY CONCERNS

The controversy over the Glass-Steagall Act focuses on the relevance of maintaining the separation of commercial and investment banking functions in today's increasingly global financial markets.

In drafting the Glass-Steagall Act, the Senate Banking Committee was basically concerned with conflicts of interest. Their concerns, outlined by a special subcommittee chaired by Senator Glass, fall into four areas (See Senate Resolution 71 hearings, 1931):

1) Imprudent lending - a bank might make imprudent loans either to its affiliate (especially if the affiliate is in trouble), or to a customer for the purchase of securities in which its subsidiary deals.

2) Bank reputation - the reputation of the bank might be tarnished if its affiliate had financial problems or if bank customers lost money on securities purchased from the bank's affiliate.

3) Trust department risk - dealings between the bank's trust department and its securities affiliate might lead to violations of fiduciary responsibility.

4) Stock manipulation - a securities affiliate might manipulate the value of the bank's stock.

The potential for problems arising from conflicts of interest between a bank and its securities affiliate is often cited as the major concern today. A key element to the repeal of Glass-Steagall, therefore, is the degree to which the bank can be insulated from the activities of its non-bank affiliates. We believe that existing statutes and regulations form a solid basis for such insulation. A listing of these safeguards is provided in Exhibit 9. Wherever necessary, current protections can be reinforced by additional regulations to make this separation even more effective.

Imprudent Lending

The potential problems of imprudent lending by a bank to its affiliate are addressed by Sections 23A and 23B of the Federal Reserve Act which place strict limits on the terms and conditions of credit extensions and other transactions between banks and their affiliates. Section 23A restricts loans to and purchases from one affiliate to 10 percent of the bank's capital and surplus (20 percent of capital and surplus for all affiliates), and requires that all transactions be fully secured and consistent with safe and sound banking practice. Section 23B requires that all transactions between a bank and its affiliate be "arms length", that is, that the terms and conditions of the transaction must reflect prevailing market conditions.

Section 23B widens the scope of activities covered by these restrictions to include those transactions with a third party that would benefit the bank's affiliate, thus effectively covering bank loans to finance the purchase of its affiliate's securities. The extension of a bank loan to finance any purchase of securities is also subject to margin restrictions set by the Federal Reserve pursuant to the Securities and Exchange Act. Currently, a loan to finance eligible securities may not exceed 50 percent of the market value of the securities purchased.

The possibility of a bank being weakened by transactions with an affiliate are further reduced by the following provisions: bank dividend payments are limited by federal and state statutes; capital adequacy is enforced by the banking agencies; compliance with regulations is monitored by bank supervisors; bank condition is assessed through examination and quarterly reports of condition; and loans to officers, directors and major shareholders are closely regulated.

Bank Reputation

Federal deposit insurance has virtually eliminated fear on the part of insured depositors. As the Continental situation in 1984 revealed, however, uninsured depositors are still susceptible to the fears associated with potential bank failure. We must continue to rely on the bank regulatory and supervisory process to maintain overall bank soundness -- and indeed, there is a role for uninsured depositors in this process. The outflow of uninsured deposits itself is an important indication that market participants perceive a change in the risk profile of an individual institution.

The authors of the Glass-Steagall Act, however, were concerned with contagion effects between one affiliate and another; specifically, they were concerned that bank depositors would lose confidence if an affiliate of the bank incurred financial problems. The experience of the savings and loan industry provides convincing evidence that deposit insurance is very effective at reassuring holders of small deposits. And we anticipate that the financial difficulties of an affiliate will not seriously erode the confidence of large depositors as long as the supervisory process is functioning effectively. Recent events support this conclusion. Despite the problems of several securities firms which own non-bank banks, there does not appear to have been any loss of confidence by depositors in those non-bank banks.

The possibility that a customer might blame the bank for losses incurred on securities purchased from an affiliate -- and that this might ultimately lead to a loss of confidence in the bank -- has been addressed in several ways. Certainly federal deposit insurance, as discussed above, is very effective in reassuring small depositors of the safety of their funds. Additionally, Section 23B of the Federal Reserve Act prohibits banks from implying that the bank stands behind any obligations of its affiliate. Recent evidence indicates that investors who suffered losses on securities purchased through bank subsidiaries have not blamed the bank, nor have there been accusations that any bank misled investors to believe that their investment was guaranteed by the bank.

Trust Department Risk

The concern that a bank trust department might violate its fiduciary responsibility in dealings with its securities affiliate is addressed by Section 23B which prohibits a bank as a fiduciary from purchasing any asset or security of an affiliate unless the transaction is specifically authorized. Moreover, trust law prohibits self-dealing and provides trust beneficiaries protection in this regard.

Stock Manipulation

The possibility that a securities affiliate might manipulate the value of the bank's stock is dealt with by the anti-fraud provisions of the Securities and Exchange Act of 1934 which prohibits stock manipulation, insider trading and fraud. Moreover, the Securities and Exchange Commission and the federal bank regulatory agencies have regulations requiring disclosure of all material information regarding securities issued by bank holding companies and banks.

Limited Liability

The framework of banking and securities laws and regulations already in existence presents a formidable defense against improper transactions between a bank and its securities affiliate. The final element in effective insulation of a bank from its affiliates is the legal principle of limited liability. Each bank is a corporation, separate from all other corporations -- even those with which it may share common ownership. As a separate corporate entity, a bank is not liable for the actions or debts of its corporate affiliates. Thus the concept of limited liability means that creditors of a securities affiliate cannot extend their claims to the bank should the securities affiliate experience financial problems.

The principle of limited liability has been upheld by the courts except in extreme circumstances involving dishonesty or total disregard of the formal rules governing corporate behavior. Management practices that will maintain the integrity of separate corporations are quite simple and straight forward. For example, the bank affiliates must not imply that they are a single entity; separate corporate records must be kept; and the business operations of affiliates must be conducted separately. Adherence to these simple guidelines will ensure that banks will be legally insulated from any adverse financial developments of their affiliates.

Taken together, the statutes governing transactions between a bank and its affiliates, the body of securities laws, the system of bank examination and supervision, federal deposit insurance for small depositors, and the principle of limited liability ensure that the banking industry can safely offer an expanded array of financial services.

VI. EVALUATION OF THE STOCK MARKET DECLINE

Some securities industry officials have cited the events of October 19 of this year, when the stock market suffered an historic loss, as a reason not to go forward with banking law reform. Those officials, however, are never specific as to what the precise connection is between the stock market decline and banking law modernization. This is perhaps because on further examination the stock market drop provides no real argument against removing the Glass-Steagall restrictions on bank securities activities. There are a number of points to be made in this regard.

First, it should be kept in mind that the Congress and the regulators are not considering allowing banks to take long term positions in stocks -- to hold stocks for investment purposes. What is being considered are underwriting and distributing activities.

Second, one fact which was certainly brought home in the weeks after October 19 is that the financial markets are now almost completely international. Every American could watch the interaction of the stock markets around the world on television. Everyone could watch as the Hong Kong, Zurich, London, and New York markets all influenced one another. It is therefore important to note, as Exhibit 10 shows, that U.S. banks compete in the securities markets in most other major financial centers. They have apparently done so in a safe and sound manner. Thus, Glass-Steagall does not really prohibit U.S. banks from participating in the securities markets; it merely forces them to participate overseas.

Third, a preliminary review of the equity market declines and Glass-Steagall separations in the major industrialized countries suggests that Glass-Steagall restructures are irrelevant. Some nations separate commercial and investment banking, others do not, but all experienced significant equity market declines. See Exhibit 11.

Fourth, as a number of witnesses have pointed out, bank lending is in many respects more risky than underwriting. A long term loan to a corporation can carry more risk of loss than an underwriting which exposes a bank to risk of loss for only a few days. The market has just witnessed what most experts believe is the worst underwriting loss of all time -- the recent British Petroleum (BP) issue. Indeed it is hard to imagine a worse case ever occurring: BP was the largest underwriting ever undertaken; it was undertaken during the worst stock market drop in history; and the terms of the underwriting locked-in the underwriters in a manner generally not used, at least in U.S. markets. And yet this BP loss has not threatened in any way the long term strength and vitality of the U.S. underwriters that participated.

Fifth, the banking regulators and the Treasury have all reviewed their positions since October 19 and all have stated that they see no reason not to proceed with Glass-Steagall reform.

If nothing else, the events of October 19 should put to rest for all time the myth perpetuated by certain sectors of the securities industry that Glass-Steagall somehow protects us from a recurrence of 1929. We have just had a worse market loss in terms of percentages with the Glass-Steagall Act than in 1929. More and more people are recognizing that the Act has no practical function other than to protect the securities industry from competition.

In fact, if banking institutions participated more fully in the securities markets, with appropriate safeguards as recommended by the regulatory agencies, the securities markets might well be more stable. Banking institutions would bring additional capital to the markets. In addition, banking institutions traditionally take a longer term view of their financial relationships, which should help add an element of stability to the markets.

Furthermore, the banking system is the foundation of our financial system. In recent weeks we have seen again that it was the banking system that was the vehicle through which the Federal Reserve moved to stabilize our markets. We need a strong, viable banking system to ensure a strong, viable financial system; and we need to modernize our banking laws to allow banks to compete if we are to have a strong banking system.

Another event of recent weeks which has received attention is the loss suffered by The First Options subsidiary of Continental Illinois. Those concerned about First Options should take note of fundamental differences between the activities of First Options and its relationship to its parent bank in comparison to current proposals for financial structure reform.

First Options of Chicago was not engaged in securities underwriting activities, but was providing loans and clearing services to traders of financial instruments, an activity that has been carried on by Continental and other United States banks for many years without significant risk or losses. Continental was a lender to First Options prior to its acquisition, and other banks remained lenders to First Options subsequent to its acquisition by Continental. Continental's acquisition of First Options as an "operations subsidiary" was permitted because First Options's activities consisted of traditional bank lending and clearing activities, as attested to by the lack of controversy or legal challenge surrounding the acquisition. The internal lending limits which Continental temporarily violated were extra conditions required by the Comptroller's Office, in its discretion and beyond any statutory requirements as part of its approval order.

In contrast, various proposals for Glass-Steagall reform currently before Congress are characterized by much more rigid separation of the insured bank from its underwriting subsidiary or affiliate, along with increased supervisory controls and enforcement mechanisms.

While a $90 million loss is obviously substantial, and while even a temporary technical violation of conditional lending limits cannot be taken lightly, it should be noted that Continental Bank was never endangered by the temporary violation of its credit extension limits; that its parent holding company was ultimately a source of strength in a period of unprecedented market turmoil; and that, even lacking the types of additional regulatory powers that could accompany Glass-Steagall reform, the Comptroller's Office was able to monitor the situation and immediately correct an ongoing violation.

VII. WHY BANKERS OPPOSE EXTENSION OF THE MORATORIUM

Title II of the Competitive Equality Banking Act imposed a moratorium on Federal agency actions to permit banks and bank holding companies to engage in new securities, insurance or real estate activities. The legislation provides that the moratorium will expire on March 1, 1988. Further, Section 203 of the Competitive Equality Banking Act states the clear intention of Congress not to renew or extend the moratorium even if subsequent banking legislation is not passed.

Customer Benefits

The moratorium denies financial institution customers the benefit of more competitive financial markets. These benefits include more and better products and services, increased convenience, and lower prices for both individual and business customers.

States Rights and The Dual Banking System

Title II of the Competitive Equality Banking Act was opposed by The National Conference of State Legislators, the Conference of State Bank Supervisors, and the National Governors Conference. Their concern was that the moratorium directly impinged on the rights of individual states to determine the permissible activities of their banking institutions.

The dual banking system is a unique partnership between Federal and state regulatory agencies and legislatures. States have historically been allowed to charter depository institutions and determine the activities they were allowed to undertake. State chartered institutions have been supervised by state regulatory agencies that are accountable to state legislatures. They have been responsible for maintaining the safety and soundness of state-chartered institutions and assuring that these institutions effectively serve the needs of their local communities and states. With the advent of The Federal Reserve System and federal deposit insurance, a federal interest in the supervisory process was recognized. However, until now, the authority of the states to determine what types of depository institutions they wanted to charter has never been challenged.

The dual banking system has served this country well by letting each state determine the products and services that can be offered by their own state-chartered banks. This has allowed the states to serve as laboratories for experimentation with different products and services for banks. The development of NOW accounts and the granting of insurance brokerage and real estate brokerage powers to state-chartered institutions in some states are good examples of this. Title II has stopped such experimentation in the real estate, insurance, and securities areas.

A dozen states are reportedly considering granting insurance powers to their state-chartered banks. Those state-chartered banks that are members of bank holding companies will not be able to take advantage of any new laws granting insurance powers while the moratorium is in existence. Moreover, State-chartered banks with insurance powers which are acquired by bank holding companies must divest their insurance operations within two years.

The moratorium on new bank powers has held up the implementation of laws granting insurance powers to state-chartered banks, and consumers have been the losers. Given the excessive premiums for insurance identified by the Consumer Federation of America, is this really the time for Congress to deny states the right to seek to lower the cost of insurance for their constituents?

When Congress itself cannot reach a consensus on the powers for banks, it would seem appropriate to recognize the responsibilities of the states and allow appropriate experimentation to take place.

The Profits of Banking's Competitors

The moratorium on new bank powers serves to protect profits in certain segments of the securities industry that many Americans increasingly find unconscionable.

Elsewhere in this testimony the concentration in the securities industry has been well documented. Senior partners in investment firms are routinely earning tens of millions of dollars. The industry has been plagued by insider trading scandals.

Is this really the time to restrict sound competition in this industry?

The Moratorium Weakens Commercial Banks

All three bank regulatory agencies (the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation) opposed the enactment of Title II. All three agree on the need to allow banks to offer a broader array of products and services, but the moratorium goes in exactly the opposite direction.

The reason the bank regulators opposed the enactment of the moratorium is easy to understand. For reasons explained elsewhere in this testimony, bank profits are being squeezed.

Banks are finding it increasingly more difficult to serve their customers. Both bankers and their regulators view diversification of banking's income stream as the key to restoring profitability.

Title II of the Competitive Equality Banking Act prevents the diversification of banking's income base and throws roadblocks in the way of banks serving their customers. Existing laws such as the Bank Holding Company Act were specifically designed to give the regulators some flexibility to respond to changes in the financial services marketplace. Regulators have the responsibility to balance the need to maintain safety and soundness with the need to provide for the efficient delivery of financial services. The moratorium prevents them from doing so.

The Moratorium Discriminates Against Banks

Other firms in the financial services industry are not subject to a moratorium on their efforts to develop new products and services that compete directly with the loans and deposits provided by commercial banks. While banks continue to lose their "bread and butter" commercial loan business to the commercial paper market, securities firms remain free to develop new products backed by mortgages, auto loans, and credit card receivables, which take loan business away from banks.

Securities firms and insurance companies are also still free to develop new products that compete directly with bank deposits. Examples include money market mutual funds which compete directly with deposits, and cash management accounts which combine the features of money market funds, check writing, debit cards and the ability to make investments. These accounts have proved to be very appealing to individuals and small businesses. Single premium deferred annuities and guaranteed investment contracts enable insurance companies to offer products that compete directly with bank certificates of deposit but still have the attributes of life insurance.

Because other firms in the financial services industry are not subject to the moratorium, they are able to diversify through acquisitions or the formation of new affiliates. A few years, ago the Prudential Insurance Company affiliated with Bache Securities to form Prudential-Bache, a diversified entity that can offer a full range of insurance and securities products, loans that compete directly with bank loans, and mutual funds that compete directly with bank deposits.

The day after the Senate Banking Committee marked up Title II, the moratorium section of the Competitive Equality Banking Act, Prudential announced it was going to diversify further by opening a nationwide chain of real estate brokerage subsidiaries. These subsidiaries will market Prudential mortgages in direct competition with commercial bank mortgages. The ability to undertake these types of affiliations and activities is available to all institutions except banks.

Summary

Addressing the growing competitive inequities within the financial services industry has proven to be extremely difficult. Because of the moratorium, Congress will now be asked to grapple with the difficult issues of financial reform in the politically charged atmosphere of the months preceding the 1988 election. Congress will be sorely tempted to merely extend the moratorium. There is precedent for this. In fact, this is what was done with the "temporary" Regulation Q ceilings instituted under the Interest Rate Control Act of 1966. The special interests that are trying to protect their markets can be expected to push hard for the politically expedient extension of the moratorium. If this is done, the result will be an extended period of one-sided and unfair injury to consumers and discrimination against the commercial banking industry.

VIII. EXHIBITS   EXHIBIT 1

GLASS-STEAGALL REPEAL, CONSUMER BENEFITS AND FINANCIAL STABILITY

I. Consumer Benefits

A. Mutual Funds

1. Shareholders are paying too much in sales charges and administrative fees for mutual funds. Sales charges or "loads" range from 4 percent to 8 percent of the amount invested. This means that for a $100 expenditure, only from $96 to $92 is actually invested. These sales charges cost consumers between $3 billion and $6.3 billion during the first six months of 1987 alone. In addition, almost one half of the 385 mutual funds surveyed by Business Week imposed administrative fees greater than 1 percent of total fund assets -- most banks charge less than 1 percent for comparable services.

2. Allowing banks to sponsor mutual funds would reduce marketing and administration costs by increasing competition.

3. The existing bank branch network -- 56,000 offices serving urban and rural areas -- is an ideal distribution system which would make mutual fund services more convenient for constituents.

4. Superior investment performance of bank-managed collective investment funds suggests that bank sponsored mutual funds may offer constituents higher investment returns.

5. Surveys show that banks are the preferred supplier of mutual fund services for many consumers -- particularly moderate income consumers.

B. Asset-Backed Securities

1. The National Association of Home Builders estimates that bank entry into mortgage-backed securities underwriting would save consumers as much as $1,000 on a $100,000 mortgage. The reduction in mortgage interest rates and monthly payments would also make home-ownership possible for more families.

2. Lower mortgage interest rates would stimulate residential construction, resulting in more jobs and increased tax revenues.

3. Private mortgage and asset-backed securities underwriting is highly concentrated, keeping the cost of mortgage credit higher than it should be.

4. Bank participation in underwriting asset-backed securities would increase competition, reduce underwriting fees, improve liquidity and encourage innovation resulting in lower borrowing costs for constituents.

C. Commercial Paper

1. Five securities firms control 95 percent of the market for dealer-placed commercial paper. Increased competition from bank participation is likely to reduce costs and improve service for issuers.

2. The loss of prime commercial customers leaves banks with a higher risk profile, making the industry less stable and leading to higher costs for bank borrowers. Underwriting commercial paper would allow banks to reduce operating risk by earning fee income and maintaining valuable customer relationships.

3. Banks could extend the benefits of commercial paper borrowing to more creditworthy smaller business customers who currently do not have access to the market.

D. Municipal Revenue Bonds

1. Government experts estimate municipalities could have saved some $480 million if banks had been able to compete in underwriting revenue bonds in 1986.

2. Bank participation would improve secondary market liquidity, lower underwriting fees, and increase the financing alternatives of small communities.

3. The National Governors Association, National Conference of State Legislators, National League of Cities, National Association of Counties, U.S. Conference of Mayors, and Government Finance Officers Association all support bank underwriting of revenue bonds.

E. Corporate Securities

1. The market for corporate securities underwriting is highly concentrated. Bank participation would increase competition leading to lower underwriting fees and improved service to issuers.

2. Bank competition may help price issues closer to their true market value -- a direct benefit to issuers.

3. Smaller firms and first time issuers would enjoy improved access to securities markets if banks could participate, especially in light of the decline in the number of regional securities firms.

II. Financial Stability

A. Allowing banks to serve their customers and diversify their sources of income would strengthen the financial industry and enable banks to continue to play a key role in the economy.

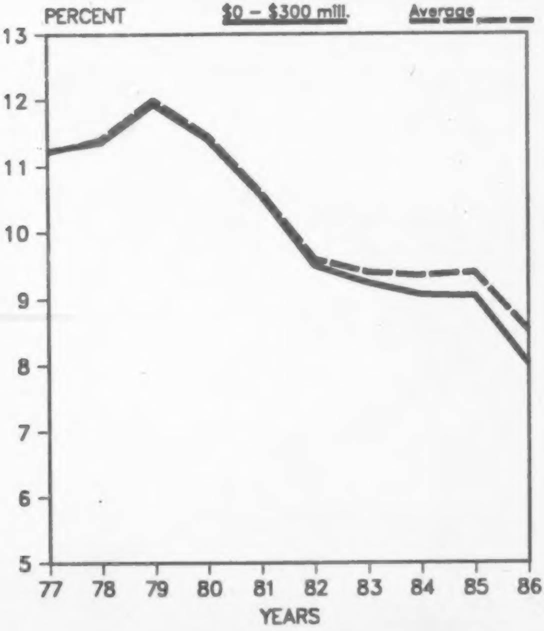
B. Banking industry participation would broaden and deepen securities markets by providing increased capital and liquidity.

C. Competition from banks would create more innovative and efficient securities markets.

D. Bankers would bring significant financial knowledge and expertise to securities markets.

E. Allowing banks to compete freely in domestic securities activities would help the U.S. remain competitive in global financial markets and would encourage employment in the U.S.

EXHIBIT 2
RETURN ON EQUITY
OF
NON-ENERGY-FARM-LDC COMMERCIAL BANKS



Note: The focused call report data excludes farm banks, banks in the energy states of Colorado, Louisiana, Oklahoma and Texas. Also excluded from the data are the ten largest U.S. Banks

EXHIBIT 3

AFFILIATIONS BETWEEN SECURITIES FIRMS AND FEDERALLY INSURED DEPOSITORY INSTITUTIONS IN THE UNITED STATES

Securities firm	Insured Depository Institution*
American Express Company IDS Securities Corp. The Robinson-Humphrey Co., Inc. Shearson Lehman Brothers, Inc.	Advisory Bank & Trust Co. American Express Centurion Bank Boston Safe Deposit & Trust Co. Savings Bank Trust Co., NW
Bear, Stearns & Co. Inc.	Custodial Trust Company
Dean Witter Reynolds Inc.	Greenwood Trust Company Hurley State Bank
Drexel Burnham Lambert Incorp.	Commercial Trust Co. Harbor Trust Company
Dreyfus Corp.	Dreyfus Consumer Bank
Eaton Vance Distributors, Inc.	Investors Bank & Trust Co.
Federated Securities Corp.	Liberty Bank and Trust, NJ
The First Boston Corporation	Universal Trust Co.
First Investors Securities Corp.	First Financial Federal Savings and Loan Association
Franklin Distributors Inc.	Pacific Union Bank and Trust Co
Goldman, Sachs & Co.	Broad Street Bank and Trust Co.
E. F. Hutton & Company Inc.	E. F. Hutton Bank
The Illinois Co., Inc.	Land of Lincoln Savings & Loan
John Hancock Subsidiaries, Inc. Sutro & Co. Incorporated Tucker, Anthony & R.L. Day, Inc.	First Signature Bank & Trust Co
Kidder, Peabody & Co. Incorp.	Monogram Bank
Merrill Lynch & Co., Inc.	Merrill Lynch Bank & Trust Co.
Prudential-Bache Securities Inc.	Prudential Bank and Trust Co.
The Travelers Corporation Dillon, Read & Co. Inc. Securities Settlement Corporation	Massachusetts Co., Inc.

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* Deposits insured by the FDIC except First Financial Federal Savings & Loan Ass and Land of Lincoln Savings & Loan, whose deposits are insured by the FSLIC.

EXHIBIT 4

FOREIGN BANKING ORGANIZATIONS WHICH HAVE ENGAGED IN SECURITIES ACTIVITIES IN THE UNITED STATES[1]

United States operation	Foreign banking organization
ABD Securities Corporation	Bayerische Hypotheken Und Wechsel Bank AG and Dresdner Bank AG
Associated European Capital Corporation	Bayerische Vereinsbank AG and Creditanstalt Bankverien
The Bank of Tokyo Trust Co.	The Bank of Tokyo, Ltd.
BHF Securities Corporation	Berliner Handels - und Frankfurter Bank
Carroll McEntee & McGinley Inc.	Hong Kong & Shanghai Banking Corporation
Deutsche Bank Capital Corporation	Deutsche Bank AG
Drexel Burnham Lambert	Groupe Bruxelles Lambert[2]
EuroPartners Securities Corporation	Banco di Roma, Caisse des Depots et Consignations, Commerzbank AG, and Credit Lyonnais
The First Boston Corporation	Credit Suisse[3]
Goldman Sachs & Co.	Sumitomo Bank, Ltd.[4]
James Capel Securities Inc.	Hong Kong & Shanghai Banking Corporation
Julius Baer Securities Inc.	Baer Holding AG
Korea Associated Securities Inc.	Cho Heung Bank, The Korea Development Bank, and five other Korean banks
Paribas Corporation	Compagnie Financiere de Paribas
Sogen Securities Corporation	Societe Generale, Paris
Swiss American Securities Inc.	Amsterdam-Rotterdam Bank NV
Swiss Bank Corporation International Securities Inc.	Swiss Bank Corporation
UBS Securities Inc.	United Bank of Switzerland
Wall Street Clearing Company	Barclays de Zoete Wedd Ltd. Barclays Bank PLC

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[1] Derived from data provided by Morgan Guaranty Trust Company, the Securities Industry Association, and the U. S. Securities and Exchange Commission.

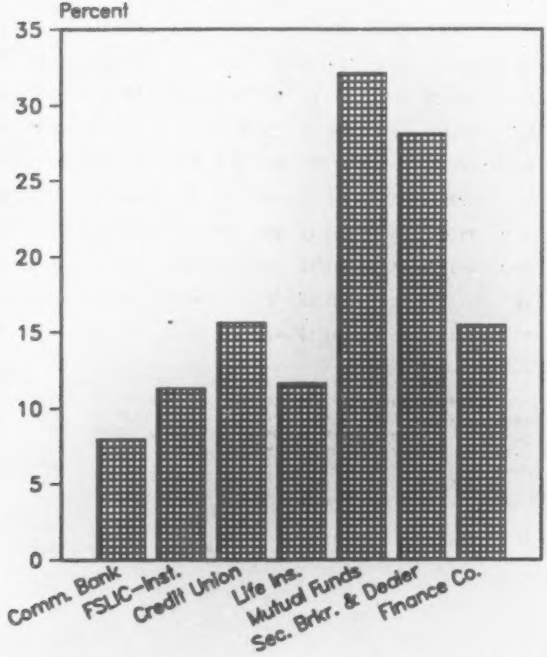
[2] Groupe Bruxelles Lambert owns a controlling interest in Banque Bruxelles Lambert and 55% of Bruxelles Lambert Holdings, which owns 28% of Drexel Burnham Lambert.

[3] First Boston Inc. owns The First Boston Corporation and 40% of Financiere Credit Suisse-First Boston (FCSFB). CS Holding owns the rest of FCSFB and Credit Suisse, a Swiss bank. Moreover, FCSFB owns 33.5% of First Boston Inc

[4] On December 5, 1986, Sumitomo Bank, Ltd., invested $425 million in a profits interest in Goldman Sachs & Co.

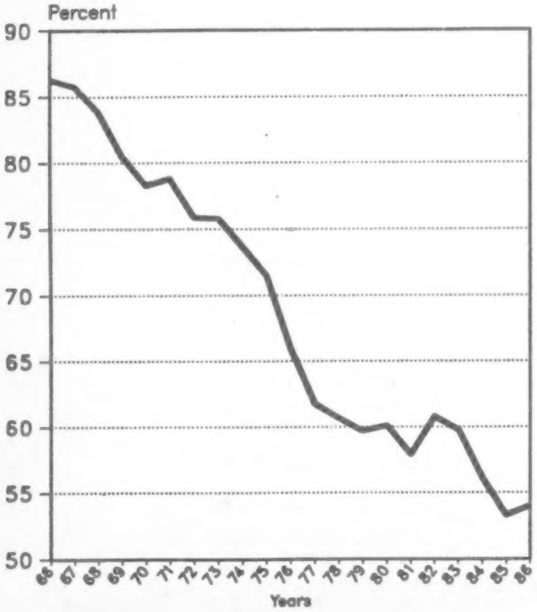
EXHIBIT 5

ANNUAL ASSET GROWTH RATES OF FINANCIAL INSTITUTIONS
1980 - 1986



Source: Federal Reserve Bulletin, New York Stock Exchange Fact Book.

EXHIBIT 6
LARGE BANK COMMERCIAL LOANS AS A PERCENT OF TOTAL SHORT-TERM BORROWING * OF NONFINANCIAL CORPORATIONS
1966-1986



* Short-term borrowing includes: Commercial Paper, Acceptances, Finance Company Loans, and Commercial and Industrial Loans at Large Banks

Sources: Federal Reserve Board Flow of Funds Accounts and Federal Reserve Bulletin.

EXHIBIT 7

Community Bank Financial Profile

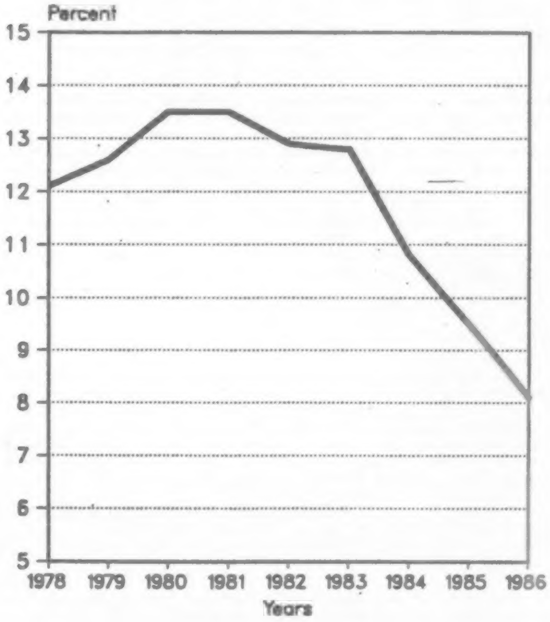
End of Year	Total Assets (mil.s)	Total Equity Capital (mil.s)	Capital Ratio (pct.)	Net Income (mil.s)	Return on End of Year Assets (pct.)	Return on End of Year Equity (pct.)	Net Interest Income (mil.s)	Net Interest Margin (pct.)	Total Loans and Leases (mil.s)	Allowance for Loan and Lease Losses (mil.s)	Loan Loss Allowance rate (pct.)	Provisions for Loan and Lease Losses (mil.s)	Loan Loss Provision rate (pct.)
1977	$245,089	$19,302	7.88	$2,339	.95	12.12	$8,059	6.04	$133,326	$1,199	.90	$478	.36
1978	$262,626	$21,104	8.04	$2,668	1.02	12.64	$9,214	6.18	$149,139	$1,323	.89	$574	.38
1979	$280,705	$23,210	8.27	$3,132	1.12	13.50	$10,446	6.63	$157,439	$1,443	.92	$628	.40
1980	$296,707	$25,303	8.53	$3,421	1.15	13.52	$11,405	7.32	$155,905	$1,495	.96	$723	.46
1981	$317,595	$27,301	8.60	$3,537	1.11	12.96	$12,290	7.60	$161,693	$1,574	.97	$821	.51
1982	$335,095	$29,184	8.71	$3,524	1.05	12.08	$12,691	7.53	$168,560	$1,688	1.00	$1,249	.74
1983	$355,306	$30,759	8.66	$3,339	.94	10.86	$12,717	7.13	$178,402	$1,848	1.04	$1,589	.89
1984	$372,779	$32,259	8.65	$3,070	.82	9.52	$12,794	6.51	$196,558	$2,200	1.12	$2,016	1.03
1985	$387,201	$33,484	8.65	$2,722	.70	8.13	$12,731	6.29	$202,355	$2,682	1.33	$3,072	1.52
1986	$396.213	$33,463	8.45	$2,034	.51	6.08	$11,846	5.90	$200,788	$3.103	1.55	$3,432	1.71

FDIC-insured commercial banks with $100 Million or Less of Assets

Source: Consolidated Reports of Condition and Income submitted to the Federal Deposit Insurance Corporation.

EXHIBIT 8

COMMUNITY BANK RETURN ON EQUITY



Source: Federal Deposit Insurance Corporation

EXHIBIT 9

SAFEGUARDS AGAINST CONFLICTS OF INTEREST AND UNFAIR PRACTICES

1. Extensions of Credit to an Affiliate - Section 23A

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) regulates extensions of credit and similar transactions between FDIC insured banks and their affiliates. Under this section an insured bank may not make a loan to an affiliate, purchase securities issued by an affiliate, or purchase any of the assets of an affiliate in an amount greater than 10 percent of the bank's capital and surplus. Further, the total of all such transactions between a bank and all of its affiliates is limited to 20 percent of the banks's capital and surplus. In all cases, the transaction must be on terms and conditions that are consistent with safe and sound banking practices. Any transaction with a third party is deemed to be a transaction with an affiliate to the extent that the proceeds are used for the benefit of, or transferred to an affiliate. Every extension of credit to an affiliate must be fully secured. A bank may not purchase a low quality asset from an affiliate unless, pursuant to an independent credit evaluation, it committed itself to purchase such asset prior to the time it was acquired by the affiliate.

The Federal Reserve Board may exempt transactions from the requirements of this section if such action is found to be in the public interest.

2. Transactions with Affiliates - Section 23B

Under the Competitive Equality Banking Act, a new Section 23B was added to the Federal Reserve Act, which places additional limitations on transactions between an FDIC insured bank and its affiliates, and covers a wider range of transactions.

In addition to extensions of credit and the other transactions covered by Section 23A, this section also applies to the sale of securities by the bank or its subsidiary to an affiliated company, the payment of money or the furnishing of services to an affiliated company, and any transaction in which the affiliate acts as an agent or broker. Further, any transaction with a third party is considered to be a transaction with an affiliate if the affiliate has an interest in or is a participant in the transaction, or if any of the proceeds of the transaction are used for the benefit of or transferred to an affiliate.

Under Section 23B, all of the transactions described above between a bank and an affiliate must be on an "arms length" basis; that is under terms and conditions substantially the same as those prevailing in the marketplace. In addition, a bank may not purchase any security during the underwriting period if a principal underwriter of that security is an affiliated company unless such purchase is specifically approved by a

LEGISLATIVE PROPOSALS TO RESTRUCTURE OUR FINANCIAL SYSTEM

WEDNESDAY, DECEMBER 9, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dodd, Dixon, Sasser, Graham, Garn, Heinz, D'Amato, Hecht, Gramm, Bond, Chafee, and Karnes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

This morning we continue our hearings on legislation to modernize our financial structure. Before the Committee today we have a panel of representatives from a wide variety of industries that would be affected by the changes embodied in the three legislative proposals before us. Following the first panel we will hear from a representative of the Financial Services Council, the successor to the Mayflower Group.

I am encouraged to hear that the Japanese Government is moving to consider repeal of its own version of the Glass-Steagall Act, the so-called Article 65. Removal of that barrier in Japan makes it imperative to move forward in this country. If banks are permitted to engage in securities activity anywhere in the world except the United States our firms will be at a significant competitive disadvantage.

Securities firms have a comparative advantage in providing services denominated in the currency of their home nation. Dollar houses are predominantly U.S. firms and Yen services appear to be most competitively offered by Japanese firms. If we deny U.S. banks the opportunity to underwrite securities in their home market they will be deprived of their comparative advantage.

Furthermore, they will be denied the right to underwrite securities in the U.S. market while several foreign banks are permitted to underwrite securities in this country as a result of the grandfather clauses in the International Banking Act of 1978.

We should go ahead with repeal of Glass-Steagall regardless of the decision of the Japanese Government. The benefits to the United States are sufficient reason by themselves. The fact that the movement is afoot to repeal Article 65 in Japan merely reinforces the need to create good public policy.

Before we begin I have statements of Senators Dixon, Chafee, and Karnes to be inserted in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator Dixon. Mr. Chairman, I am pleased to be here this morning on this fifth day of hearings on the major reform proposals introduced by a number of members of this committee. We have an expert group of witnesses before us again this morning, and I look forward to their testimony.

I am openminded on what reform the second banking bill should take. However, I again want to make it clear that there is one provision that does not belong in any second banking bill, and which will not be included if I have anything to say about it—an extension of the current moratorium.

I strongly believe that Congress, and not the regulators or the courts, should be making financial services policy. However, attempting to freeze the status quo is no substitute for doing what must be done—acting on the substantive issues involved. The world is changing; financial markets are changing. Moratoriums cannot change those facts. They must be faced. Our financial services regulatory framework must be updated. That updating should occur here in Congress, but if Congress cannot or will not act, then that updating will occur anyway.

Reform through tortured regulatory or legal interpretations or existing statues will be uneven, and will likely create as many problems as it solves. I urge all interested parties, therefore, to work with the Banking Committee in crafting sound and reasonable legislation that addresses the issues. I want to make it clear that this Senator will not be a party to any effort to prevent the committee from meeting the commitments it made when acting on the first banking bill earlier this year.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR JOHN H. CHAFEE

Senator Chafee. Mr. Chairman, today we will hear from interested parties affected by each of the bills before us, but who are not principally in banking or securities.

The Proxmire-Garn bill focuses essentially on integrating commercial banking and securities activities and that is where I think out attention should be directed. I commend Senators Graham, Wirth, D'Amato, and Cranston, for bringing forward bills that force us to review the question and benefits of restructuring the whole financial services industry. Nevertheless, these proposals beg as many questions as they ask. These bills help informed debate but should not be seen as the bedrock for the next step to be taken, and one that should be completed by March 1, 1988. The Glass-Steagall rewrite, advocated in the Proxmire-Garn bill, represents the best starting point, and it is certainly amendable. Moreover, safety and soundness itself militates in favor of not adopting too broad and sweeping a change.

The reason I focus on securities and not insurance and real estate is twofold. First, the commercial banking and investment banking industries have over the last decade increasingly converged, ultimately becoming involved in a legalistic issue of whether certain financial instruments, such as commercial paper or mutual funds, are or are not securities and whether they are or are not incidental to commercial banking. It then depends on which regulator does the construing of the law, often resulting in law suits which work their way toward the Supreme Court. This convergence is not as clear-cut with regard to insurance and real estate. I think an easier way to obviate all that in unconstructive effort is through the Proxmire-Garn approach, but broadened to make it a more balanced bill.

Second, I do not feel that commercial banks should increase their role in the insurance and real estate areas at this time. In fact, I do not feel that commercial banks should presently issue insurance beyond the powers currently granted by Congress. During the CEBA debate on the Senate floor, I had introduced amendments to freeze bank activities in insurance and real estate during the moratorium, were that necessary. It was not then, and I am hopeful it will not be now.

How does this jibe with my agreement not to extend the moratorium? Because we the Senate Banking Committee will be making a conscious decision on legislation. The moratorium was instituted to allow the Committee to consider the issues as we are doing and then create law that embodies those decisions and their ramifications. This is so we can move forward, especially given the March 1, 1988 deadline.

Mr. CHAIRMAN. I look forward to the presentations and debate today.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR DAVID KARNES

Senator KARNES. Thank you Mr. Chairman. It is indeed a pleasure for me to participate in these historic discussions and legislative effort to restructure the financial services industry. We now have a wide range of proposals to consider from the more specific Proxmire/Gran bill, S. 1886, to the comprehensive restructuring proposals contained in the Cranston-D'Amato bill, S. 1905.

The moratorium provided the Congress and specifically this committee in the Senate the opportunity to review what has already transpired in the financial services industry in the absence of any major legislative reform. The testimony and dialog yesterday with the representatives of the banking industry and the securities industry illustrated that we have gone too far to turn the clock back now. The banking industry is already in the securities business and the securities industry is already in the banking business. The Congress should exert its legislative role on this matter and provide the proper direction to the courts, regulators, and participants in the industry as to the framework that we feel is desirable. I applaud all six of my colleagues who have cosponsored legislation to do just that.

majority of the bank's directors who are not officers or employees of the bank. A bank may not purchase as a fiduciary any securities or assets of an affiliate unless specifically authorized by the trust agreement, court order, or other law governing the fiduciary relationship. Finally, a bank may not publish any advertisement or enter into any agreement stating or suggesting that the bank shall be responsible for the obligations of an affiliate. The Federal Reserve may exempt certain transactions from the requirements of this section if such exemption is found to be in the public interest.

3. Purchase of Securities From Directors

Section 22(d) of the Federal Reserve Act (12 U.S.C. 375) provides that a member bank may not purchase from any of its directors any securities or other property unless such purchase is made in the regular course of business and on an "arms length" basis, or when such purchase is approved by a majority of the bank's board of directors. Similarly, a member bank may only sell securities or other property to a director is such sale is on an arms length basis and in the regular course of business.

4. Loans to Officers, Directors and Major Shareholders

Section 22(g) and (h) of the Federal Reserve Act (12 U.S.C. 375a-b) regulates extensions of credit by an FDIC insured bank to officers, directors and major shareholders of that institution. A major shareholder is defined as any person or group of persons with the power to vote 10 percent or more of any class of the bank's voting securities. These restrictions also apply to extensions of credit to an officer, director or major shareholder of an affiliated company or a parent bank holding company, or a company controlled by such persons, or to a political action committee controlled by or established for the benefit of such persons. Such loans may only be made on an "arms length" basis, and may not involve more than the normal risk of repayment. Various approvals and restrictions are placed on the amount and purposes for which these loans may be made.

Extensions of credit made to officers, directors and major shareholders of correspondent banks are similarly regulated. (12 U.S.C. 1972)

5. Anti-Tying Provisions

The Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1971 et. seq.) generally provide that a bank may not furnish any service or change the cost of any service, on the condition that a customer obtain some additional service from that bank or the parent holding company or subsidiary thereof, or provide an additional credit, property or service to the bank or holding company. An exception is made to permit a bank to require that the customer obtain an additional loan, discount, deposit or trust service, and for additional conditions that related to and usually required in connection with the bank service in question, as well as conditions imposed by the bank to assure the soundness of the credit.

For purposes of these restrictions, a "bank" is defined in the same manner as under the Bank Holding Company Act, which now includes FDIC insured banks.

6. Restrictions on Dividends

National banks may not pay any dividends if its losses equal or exceed its undivided profits, after subtracting losses and bad debts. (12 U.S.C. 56). The approval of the Comptroller of the Currency is required before any dividends may be declared in excess of the institution's net profits for that year, combined with its retained net profits of the preceding two years (less any required transfers to surplus). (12 U.S.C. 60). Restrictions on dividends declared by state chartered banks may also be imposed under state laws.

7. Management Interlocks

The Depository Institution Management Interlocks Act (12 U.S.C. 3201 et. seq.) generally provides that a management official of a depository institution or holding company may not serve as a management official with another depository institution or holding company not affiliated with the first institution, if an office of both institutions are located within the same metropolitan area. However, a management official of an institution with $1 billion or more in assets may not serve as a management official in any other nonaffiliated depository institution with assets of $ 500 million or more.

8. Securities Disclosure Requirements

Pursuant to section 12(i) of the Securities and Exchange Act of 1934 (15 U.S.C. 78l(i)), FDIC insured banks are exempt from the registration requirements of that Act with respect to their own securities. However, the federal bank regulatory agencies are directed by that statutory provision to promulgate regulations which are substantially similar to the regulations issued by the SEC. Thus, banks with 500 or more shareholders and at least $ 1 million in assets are required to file registration statements and periodic reports, issue proxy statements and make other public disclosures in a similar manner as other publicly held corporations. (See, e.g. 12 C.F.R. pt. 206).

9. Anti-Fraud Provisions

Banks are not exempt from the anti-fraud provisions of the Securities Act of 1933 or the Securities and Exchange Act of 1934. Under these laws it is unlawful to employ any device, scheme or artifice to defraud or to make any untrue statement of a material fact, or to omit to make a statement necessary to make a statement already made not misleading, or to engage in any other act or practice or course of business which would operate as a fraud on a person in connection with the purchase or sale of any security. (See, e.g. 17 C.F.R. 240.10b-5). Under these provisions, for example, it has been held that a bank cannot take actions which have the effect of manipulating the market for a security, and cannot trade based on inside information.

10. Capital Adequacy

The federal bank regulatory agencies determine minimum capital ratios through administrative actions. In general, the bank agencies have set the minimum ratio of total capital to adjusted total assets at 6%. The agencies have the authority to establish higher capital ratios as may be necessary, either on an individual basis or through general regulations. Thus, for example, a newly chartered bank, a bank receiving special supervisory attention, or a bank having a high proportion of off-balance sheet risks (such as standby letters of credit) may be required to have a higher capital ratio. In addition, under the International Lending Supervision Act (12 U.S.C. 3907), a banking agency may issue a directive to a particular institution requiring that institution to establish a plan to increase its capital.

11. Authority to Examine Affiliates

Under the Bank Holding Company Act (12 U.S.C. 1844), the Federal Reserve Board is authorized to conduct examinations of all subsidiaries of a holding company, including the nonbanking subsidiaries. In addition, under the Federal Reserve Act (12 U.S.C. 338), the Board may examine all affiliates of a state member bank. Similar authority is granted to the FDIC with respect to affiliates of insured banks (12 U.S.C. 1820(b)), and the Comptroller of the Currency, with respect to national banks (12 U.S.C. 481).

12. Bank Loans Used to Purchase Securities From Affiliates

Section 7 of the Securities and Exchange Act (15 U.S.C. 78g) authorizes the Federal Reserve Board to promulgate regulations governing the amount of credit which may be used to finance the purchase of any security. Board regulations under this authority currently limit the maximum loan value of any margin stock (securities listed on any national exchange or issued by an investment company), except options, at 50 percent of current market value.

(12 C.F.R. 221.8.) Section 11(d) of the Securities and Exchange Act (15 U.S.C. 78j) prohibits a securities firm from arranging for an extension of credit to or for a customer on any security which was part of a new issue the securities firm participated in the distribution of within the past 30 days. In addition, both sections 23A and 23B of the Federal Reserve Act cover loans made to third parties which are used for the benefit of an affiliate, and thus would appear to include extensions of credit used to purchase securities from an affiliate.

13. Conversion of Bad Bank Loans Into Bond Issues

The disclosure requirements of the Securities Act of 1933 (15 U.S.C. 77g,77j & 77aa) require detailed disclosure concerning the financial condition of the issuer and the intended use of the proceeds from the offering. The anti-fraud provisions, as noted above, require the inclusion of statements necessary to make a statement previously made not misleading. These requirements make it highly unlikely that a bank could package bad loans into securities to be distributed to the public, without disclosing the quality of the collateral backing the securities.

EXHIBIT 10

UNITED STATES BANKS WHICH ARE AFFILIATED WITH FOREIGN SECURITIES FIRMS

United States Bank	Foreign Securities Firm	Market
Bank of America, N.T. & S.A.	BA (Asia) Limited	Hong Kong
Bank of America, N.T. & S.A.	Bank of America International Limited	United Kingdom
Bankers Trust Company	Bankers Trust International	United Kingdom
Bankers Trust Company	BT Australia Limited	Australia
The Chase Manhattan Bank, N.A.	Chase Manhattan Asia Limited	Hong Kong
The Chase Manhattan Bank, N.A.	Chase Manhattan Bank (Switzerland)	Switzerland
The Chase Manhattan Bank, N.A.	Chase Manhattan Limited	United Kingdom
ChemicalBank	Chemical Asia, Limited	Hong Kong
ChemicalBank	Chemical Australia International, Ltd.	Australia
ChemicalBank	ChemicalBank (Suisse), S.A.	Switzerland
ChemicalBank	ChemicalBank International	United Kingdom
Citibank, N.A.	Asia Pacific Capital Corporation, Ltd.	Hong Kong
Citibank, N.A.	Citicorp Bank (Switzerland) AG	Switzerland
Citibank, N.A.	Citicorp Capital Markets Australia, Ltd.	Australia
Citibank, N.A.	Citicorp International Bank Limited	United Kingdom
Citibank, N.A.	Citicorp International Limited	Hong Kong
Citibank, N.A.	Citicorp International (Singapore), Ltd.	Singapore
Citibank, N.A.	Vickers Dacosta	Japan
Continental Illinois National Bank and Trust Company of Chicago	Continental Illinois Limited	United Kingdom

(continued)

ed States Bank	Foreign Securities Firm	Market
First National Bank oston	Boston Australia Limited	Australia
First National Bank hicago	First Chicago Hong Kong Limited	Hong Kong
First National Bank hicago	First Chicago Limited	United Kingdom
t Interstate Bank fornia	First Interstate Capital Markets, Ltd.	United Kingdom
ng Trust Company	Irving Trust International Limited	United Kingdom
facturers Hanover Trust any	Manufacturers Hanover Asia, Ltd.	Hong Kong
facturers Hanover Trust any	Manufacturers Hanover Australia Limited	Australia
facturers Hanover Trust any	Manufacturers Hanover Limited	United Kingdom
land National Bank	Maryland Bank International, SA	Luxembourg
an Guaranty Trust Company	J.P. Morgan (Australia) Limited	Australia
an Guaranty Trust Company	Morgan Guaranty Limited	United Kingdom
an Guaranty Trust Company	Morgan Guaranty (Switzerland) Ltd.	Switzerland
an Guaranty Trust Company	Morgan Guaranty Pacific Limited	Singapore
h Carolina National Bank	Carolina Bank Limited	United Kingdom
blic National Bank of N.Y.	Republic NB N.Y. (Singapore) Ltd.	Singapore
s National Bank	Riggs - U. K. London Limited	United Kingdom
rity Pacific National Bank	Security Pacific Australia Ltd.	Australia
rity Pacific National Bank	Security Pacific Bank (Asia) Ltd.	Singapore
rity Pacific National Bank	Security Pacific Holings Limited	United Kingdom
s Fargo Bank, NA	Wells Fargo Limited	United Kingdom

Source: Board of Governors Federal Reserve System

EXHIBIT 11

FOREIGN BANK REGULATION AND STOCK MARKET DISRUPTIONS

Country	Glass-Steagall-like limits on banking firms' securities activities?	August through October 1987 stock market decline
Canada	no*	23.6%
France	no	25.0%
Japan	yes	5.6%
The Netherlands	no	28.1%
Sweden	no	13.2%
Switzerland	no	16.7%
West Germany	no	25.1%
United Kingdom	no	34.1%
United States	yes	19.7%

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* as of June 30, 1987

Mr. Chairman, it is a special pleasure for me to recognize one of Nebraska's own on the panel of expert witnesses. Tom Olson, president of the Independent Bankers Association of America and the president of Lisco State Bank, Lisco, NE, is a good friend and respected leader in banking circles throughout the country. Tom is an articulate and innovative spokesman for the community bankers in Nebraska and the Nation. I look forward to his testimony and input as well as the rest of the expert panel assembled today.

Thank you Mr. Chairman.

The CHAIRMAN. Gentlemen, we have your opening statements and we would appreciate it very much if you would confine your oral delivery to 10 minutes if possible, or less if you can squeeze it in.

Our witnesses are Kent Colton, executive vice president and chief executive officer of the National Association of Home Builders; Robert Googins, executive vice president, Connecticut Mutual Life Insurance Co., Hartford, CT. Mr. Googins is testifying on behalf of the American Council of Life Insurance. Norman Flynn, first vice president of the National Association of Realtors; William Bailey, Jr., vice president of the Independent Insurance Agents of America; and Thomas Olson, president of the Independent Bankers Association and president of the Lisco State Bank, Lisco, NE.

Mr. Colton, will you begin, sir?

STATEMENT OF KENT W. COLTON, EXECUTIVE VICE PRESIDENT AND CEO, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. COLTON. Thank you, Mr. Chairman.

As you indicated, my name is Kent Colton and I'm the executive vice president and chief executive officer of the National Association of Home Builders. On behalf of the 150,000 member firms of NAHB, I am certainly pleased to be here to discuss our views of financial services legislation.

At the outset, let me acknowledge that although NAHB fully supports the participation of banks and thrift institutions in mortgage-backed securities activities, we do not have formal policy in many aspects related to the restructuring of the financial services industry. For that reason, I will focus my remarks primarily on those areas where we have a formal position.

AREAS OF INTEREST TO NAHB

In essence, I would characterize that as, first, supporting the full participation of banking and thrift institutions in mortgage-related securities activities; and second, strongly opposing the direct investment by banks in real estate activities; and third, encouraging a careful step-by-step approach in the evolution of financial services especially in light of the market uncertainties over the last several months.

Let me explain each of these three areas in greater detail. NAHB supports the full participation of banking and thrift institutions in mortgage-related securities activities and our written testimony goes into full detail as to the nature of what that participation should be from our perspective.

We feel this way for three primary reasons. First, the critical and expanding role of the mortgage securities market in housing finance; second, the need for greater competition in underwriting and dealing activities; and third, the fact that such legislation would provide opportunities to enhance the earnings and liquidity of banks and thrifts without incurring undue risk.

Mortgage-related securities now represent the primary means of accessing capital markets for housing finance. More than half of all mortgages originated are now securitized in one form or another. Underwriting and dealing in mortgage-related securities markets, however, are currently highly concentrated.

As tables 3 and 4 in the written testimony highlight, in 1986, 2 firms had 58 percent of the underwriting market and 10 firms accounted for 96 percent of the underwriting market in mortgage-backed securities. Increased competition in this market is needed to reduce underwriting and trading fees as well as to improve access to the capital markets for small issuers and such competition should also bring benefits to the home buyer in terms of lower mortgage-related costs.

Now let me move on to our position regarding direct investment in real estate by banks. As I think you probably know, NAHB has been a longstanding opponent to banking organizations being allowed to engage directly in real estate development and investment activities. These activities involve a high degree of risk which we feel is incompatible with the safety and soundness of the banking system and the integrity of the Federal Deposit Insurance System.

We also believe that bank entry into real estate development and investment produces no public benefit because these markets are already highly competitive.

Our written testimony goes into some of the details of our position regarding both legislation and regulation related to direct investment by banks and bank holding company affiliates. We draw distinctions in terms of what sorts of activities should be prohibited when you talk about banking activities in direct investment in real estate. When we get into the question and answers I'd be glad to talk about some of those details if you are interested.

We take this general position based on past experience as well as our view of the future. Past experience has demonstrated that real estate investment and development powers have caused serious difficulties for financial institutions, especially in areas of economic downturn. Financial institutions in the oil-related States were not structurally prepared for the economic downturn that occurred when oil prices plummeted. State laws in Texas permitted direct investment by banks and thrifts and many of the institutions which have become insolvent during the most recent downturn had invested heavily in real estate.

In addition to the economic and cyclical risks of direct real estate investment, legislators and regulators have long recognized and been wary of the inherent illiquidity of real estate equities. Such illiquidity is at complete odds with both the function and safety of financial institutions. Further, one of our greatest concerns relates to the fact that if banks or bank holding company affiliates are given direct investment powers in real estate, it puts them in a position of direct competition with their borrowers while still leaving the borrower dependent upon the lender for the funds to produce that product.

We have, for example, a variety of builders who have gone to a lender about a loan on a particular development project have been told that they would not be given that loan unless there was some kind of direct participation by that financial institution.

THOUGHTS ON LEGISLATION

Now that I've commented on several of the specific views that we have as far as financial services activities, let me step back and talk a minute about the overall legislation.

While we fully support the ability of banking organizations to underwrite and deal in mortgage-backed securities and we feel some additional expanded powers are appropriate, we also feel Congress should move carefully as they review the overall restructuring of the financial services industry. Because of the stock market crash and the market is still jittery from that experience, Congress should institute a step-by-step transition into new activities.

Last August, Congress passed a moratorium to halt further regulatory decisions which would expand investment powers in banks and bank holding companies in the area of securities, insurance and real estate. The moratorium provided Congress with two opportunities. First, it encouraged Congress to look at the question of new investment powers within a specified period of time in a relatively stable structural environment; and second, the moratorium allowed Congress to make it clearer that it was their role to determine the future structure of the industry.

Without congressional action and direction, the regulators are faced with reacting, often haphazardly to developments that determine their policy and not vice versa. Now with the March 1 moratorium date rapidly approaching, Congress really has three alternatives. First, you can decide which additional powers you want to give to the banking industry and how to structure that framework for the future. Second, Congress could allow the moratorium to expire and permit Federal and State banking regulators to determine the future of the financial services industry; or third, Congress can choose to extend the moratorium.

NAHB feels that allowing the moratorium to expire with no legislative decision is the least desirable of these three options.

We fully support the position that Congress should provide direction to the regulators concerning which new investment authorities are permitted for financial institutions.

NAHB also opposes the wholesale expansion of the moratorium. The marketplace is already moving and the actions of Congress cannot hide the realities of the free market system.

However, we are also concerned that we can move too rapidly. Therefore, we feel that some combination of the first and the third option would be most appropriate. Such an approach would allow for expanded powers in specific areas such as the underwriting of mortgage-backed securities and mortgage revenue bonds, while at the same time extending the moratorium in areas where considerations of safety and soundness raise serious doubts such as the area of direct real estate investment which I've already discussed.

The precise combination of what items should be included in the expanded set of powers and what items should be included in the moratorium should naturally depend on the evidence which is presented at these hearings.

However, it seems to us that such a course of action will allow a step-by-step evolution of the financial services industry and one that will provide for both expansion on the one hand and considerations of safety and soundness on the other.

Thank you very much.

[The complete prepared statement of Kent W. Colton follows:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

on

THE FINANCIAL MODERNIZATION ACT OF 1987

and

THE FINANCIAL SERVICES OVERSIGHT ACT

December 9, 1987

My name is Kent W. Colton and I am Executive Vice President and Chief Executive Officer of the National Association of Home Builders. On behalf of the 150,000 members of the National Association of Home Builders, I am pleased to be here to offer our views on S.1886, the Financial Modernization Act of 1987; S.1891, the Financial Services Oversight Act; and S.1905, the Depository Institution Affiliation Act.

I would like to acknowledge at the outset that although NAHB fully supports the participation of banks and thrift institutions in mortgage-backed securities activities, we do not have formal policy on many aspects related to the restructuring of the financial services industry. For that reason, I will focus my remarks primarily on those areas where we do have a formal position. In essence I would characterize our position as:

- Supporting the full participation of banking and thrift institutions in mortgage-related securities activities.
- Strongly opposing the direct investment by banks in real estate activities.
- Encouraging a careful "step-by-step" approach in the evolution of the financial services industry, especially in light of the market uncertainties over the last several months.

Let me explain each of these positions in greater detail.

NAHB supports full participation of banking and thrift institutions in mortgage-related securities activities for three primary reasons: first, the critical and expanding role of the mortgage securities market in housing finance; second, the need for greater competition in underwriting and dealing activities; and third, the fact that such legislation would provide opportunities to enhance the earnings and liquidity of banks and thrifts without incurring undue risk.

Mortgage-related securities now represent the primary means of accessing capital markets for housing finance. More than one half of all mortgages originated are now securitized in one way or another.

Underwriting and dealing in mortgage related markets are currently highly concentrated among a small number of investment banking firms. In 1986, two firms had 58% of the underwriting market and ten firms accounted for 96%. Increased competition in this market is needed to reduce underwriting and trading fees as well as to improve access to capital markets for small issuers.

Mortgage-backed securities powers are integral to the ability of the American banking systems to compete in an emerging system of global financial competition. The ability of U.S. banks to compete equitably with foreign banking concerns is a key to dealing with future issues related to international trade and economic development, as well as to international and domestic financial stability.

However, when it comes to direct investment in real estate by banks we have a different view. As you know, NAHB has been a long-standing opponent of banking organizations being allowed to engage directly in real estate development and investment activities. These activities involve a high degree of risk that is incompatible with the safety and soundness of the banking system and the integrity of the federal deposit insurance system. We also believe that bank entry into real estate development and investment produces no public benefit because these markets are already highly competitive.

Regulation of lending and investment activities of federally insured depository institutions was established to ensure their safety and soundness and to prevent unfair competition by institutions benefiting from federal backing. The current dual regulatory system of federal and state-chartered institutions is confusing and, in some instances, has created significant liabilities for the federal insurance funds. This is the case, for example, with certain state guidelines on direct real estate investment by state-chartered financial institutions. For these reasons, we believe Congress needs to take charge of this area and provide direction to the regulators as we will outline later in this testimony.

Past experience has demonstrated that real estate investment and development powers have caused serious difficulties for financial institutions -- especially in areas of economic downturn. Financial institutions in the oil related states were not structurally prepared for the economic downturn that occurred when oil prices plummeted. State laws in Texas permitted direct investment by banks and thrifts and many of the institutions that have become insolvent during the most recent downturn had invested heavily in real estate.

Direct real estate investments and their role in recent financial institution failures are still being studied. However, information available at this time indicates that direct real estate investments are quite capable of pushing an institution into insolvency if area real estate values decline rapidly. Because there have been no conclusions to these studies, we believe it would be inappropriate to simply allow the real estate moratorium, which is currently in effect, to expire on March 1.

In addition to the economic and cyclical risks of direct real estate investment, legislators and regulators have long recognized and been wary of the inherent illiquidity of real estate equities. Such illiquidity is at complete odds with both the function and safety of financial institutions. Finally, the intermediary role of banks and thrifts does not encompass entrepreneurial risk-taking posed by speculating about the property's potential profitability, rather than knowledge of a borrower's credit. Nor does it encompass a situation which pits lenders and borrowers in direct competition for their product while leaving the borrower dependent upon the lender for the funds to produce that product.

While we support the ability of banking organizations to underwrite and deal in mortgage-backed securities, and we think some expanded powers are appropriate, we also feel Congress should move carefully as they review the restructuring of the financial services industry. Because of the stock market crash and because the market still seems to be jittery from that experience, Congress should institute a step-by-step transition into any new activities, and care should be made to consider carefully what expanded powers are most appropriate and consistent with the safety and soundness of the banking system.

Last August Congress passed the Competitive Equality Banking Act. The Act created a moratorium to halt further regulatory decisions which would expand investment powers of banks and bank holding companies in the areas of securities, insurance and real estate. The moratorium provided Congress with two opportunities. First, the moratorium encouraged Congress to look at the question of new investment powers within a specified period of time. Within such a review Congress has the opportunity to study the current structure of the financial services industry in a relatively stable environment and determine which products and services they feel are appropriate. Second, the moratorium provided Congress the opportunity to clarify that it was the role of Congress to determine the future structure of the industry. Without Congressional direction, the regulators are faced with reacting, often haphazardly, to developments that determine their policy and not vice versa.

Now with the March 1, 1988 moratorium expiration date approaching rapidly, Congress can do three things. One, it can decide which additional powers it wants to give to the banking industry and how to structure the framework for the new investment authorities. Two, Congress can allow the moratorium to expire and permit federal and state banking regulators to determine the future of the financial services industry. Or three, Congress can choose to extend the moratorium.

NAHB feels that allowing the moratorium to expire with no legislative decision is the least desirable of all three options. We fully support the position that Congress should provide direction to the regulators concerning which new investment authorities are permitted for financial institutions. To simply allow the moratorium to expire would, in our view, be counterproductive and the equivalent of telling the regulators that Congress will no longer provide the oversight and direction for the financial services industry.

NAHB also opposes the wholesale expansion of the moratorium. The market-place is already moving, and the actions of Congress cannot hide the realities of the free market system.

However, we are also concerned that we can move too rapidly. Therefore, we feel that some combination of options one and three may be most appropriate. Such an approach would allow for expanded powers in several specific areas such as the underwriting of mortgage backed securities and mortgage revenue bonds, while at the same time extending the moratorium in areas where considerations of safety and soundness raise serious doubts. An illustration of this is the area of real estate investment where we do not believe that permitting banks to have direct investment in real estate powers would be productive to anyone's interests at this time. The precise combination of what items should be included in the expanded set of powers and what items should be prohibited while a more careful review is made should depend on the evidence which is presented over the next three months. However, it seems to us that such a course of action will allow a step-by-step evaluation of the financial services industry, and one that will allow both expansion on the one hand and consideration of safety and soundness on the other.

At this point I would like to expand our views on real estate equity investments and development, focusing on current regulatory efforts to limit these activities. I will also discuss our support for mortgage-backed securities underwriting.

Real Estate Equity Investments and Development

As this Committee well knows, NAHB has been a long-standing opponent of banking organizations being allowed to engage in real estate development and investment activities. We firmly believe that such real estate activities are unrelated to the business of banking, high-risk and fraught with potential for conflicts of interest. We also believe that bank entry into real estate development and investment would produce no public benefits, in view of the already highly unconcentrated and competitive nature of these markets.

In this regard, our concerns about the risks of these activities to the safety and soundness of the banking system have been consistent with those reflected in activities of federally chartered depository institutions, and we have encouraged establishment of federal controls on real estate investment and development activities of state-chartered institutions. At present, neither national banks, state member banks nor BHC's may engage in real estate investment and development activities except under quite limited circumstances. We do not believe a change to this federal policy is warranted by recent actions by a number of states to permit state-chartered banks and thrifts to engage in a broad range of real estate investment and development activities. Indeed, the Federal Home Loan Bank Board has been compelled by the dramatically high risks and losses that these activities have incurred for both S&L's and the FSLIC fund, to issue a regulation limiting -- by as much as 90% in some cases -- the extent to which S&L's can exercise their state-authorized powers to engage in real estate investment and development.

NAHB has urged the Federal Reserve Board to exercise its authority to prohibit real estate activities of BHC banks and their subsidiaries through the application of Section 4(c)(8) of the BHCA to all nonbanking subsidiaries, direct and indirect, of all bank holding companies -- including holding companies that own state nonmember banks. This restriction would apply whether or not the bank could conduct the activity directly under state law. As a result of this action, neither nonbank subsidiaries of BHC's nor subsidiaries of BHC banks would be able to engage in real estate investment and development activities.

NAHB recognizes, nevertheless, that there are other considerations in dealing with the problem of real estate activities conducted within holding companies that own nonmember banks, including issues related to the competitive balance of institutions within states. These considerations resulted in the Board's proposed regulation to allow very limited real estate investment powers for separate subsidiaries of BHCs.

NAHB agrees on the need to reduce the risks to the banking system associated with real estate investment and development powers already granted to state-chartered institutions in 19 states, and this could be achieved by limiting such activity to nonbank subsidiaries of BHC's. However, we do not believe that in addressing this problem, it is necessary to simultaneously extend real estate powers to banking organizations in 31 other states. In our opinion, focus should be limited to dealing with the safety and soundness problems posed by the participation of nonmember BHC-owned banks and their subsidiaries in real estate investment activities.

Scope of Investments and "Closely Related" Test

With respect to the appropriate scope of real estate activities, NAHB believes that any passive investment, if it is to be construed as "closely related to banking and a proper incident thereto," should be structured as the functional equivalent of a loan with the BHC's involvement similar to its traditional role as extender of credit. One example is an equity investment in a completed real estate project, that serves as the functional equivalent of permanent mortgage financing.

On the other hand, speculative acquisitions of undeveloped or partially developed land to be held for investment or future development are, in our view, simply unacceptable and wholly irreconcilable with the "closely related" test. The following should be strictly prohibited:

1. Any investment in land acquisition and development that is undertaken in anticipation of holding the property for speculative future appreciation in value;

2. The acquisition of a majority interest in any project, or active management of the project;

3. The initiation by the BHC of any real estate investment project (as with a loan, the BHC should respond to requests for financing and do so for projects that have completed plans for their use);

4. Investment in a project in which profitability depends upon capital appreciation rather than on operating profit.

Underwriting and Dealing in MBS

NAHB advocates underwriting of mortgage-related securities by banks and thrifts themselves. Thus, we believe that legislation should authorize expanded activity at both the holding company and institutional levels for both banks and thrifts.

NAHB supports full participation of banking and thrift institutions in mortgage-backed securities activities for 3 primary reasons: first, the critical and expanding role of the mortgage securities market in housing finance; second, the need for greater competition in underwriting and dealing activities; and, third, the much-needed opportunities to enhance the earnings, liquidity and profitability of banks and thrifts without incurring undue risk.

Underwriting and dealing in mortgage-related securities involves relatively low risks; and it is closely related to banks' and BHC-owned mortgage companies' activities of originating mortgages, packaging and issuing MBS, and investing in MBS. There also are substantial public benefits to be realized, especially in terms of much-needed competition, lower costs, improved service and expanded product innovation and selection. The banking industry is exceptionally experienced in analyzing and controlling both credit and market risk of mortgages and mortgage-backed securities, as well as in underwriting public agency securities -- including mortgage-backed varieties -- both domestically and abroad.

Role of the Securities Market in Housing Finance

Mortgage-related securities -- which include traditional pass-through and various debt instruments -- now account for the majority of mortgages sold in the secondary markets and represent the primary means of accessing capital markets for housing finance. Expansion of the market was facilitated by the Secondary Mortgage Market Enhancement Act of 1984, and passage of the 1986 Real Estate Mortgage Investment Conduit (REMIC) legislation has cleared the way for a stronger MBS market of greatly expanded potential. The volume of mortgage securities issued in 1986 amounted to $159.0 billion (Table 1). Mortgage securities are now as important in annual fundings as corporate bonds and, in fact, raised more funds in the credit markets in 1986. Mortgage securities now account for 22% of all mortgage debt outstanding, up from 7% in 1977 (Table 2). Over half of all mortgages originated are now securitized in one way or another. These trends are not likely to change and a significant move into the mortgage markets by private institutions is a development that can only benefit borrowers by increasing the availability of affordable mortgage credit.

Underwriting and dealing in private mortgage-related securities are activities closely related to banking. BHCs, banks and mortgage banking affiliates already issue, underwrite and deal in GNMA, FNMA, and FHLMC mortgage securities, as well as other eligible securities. They may issue and, in many cases, also underwrite and deal in their own private pass-through and CMO issues. U.S. banks may also underwrite private securities abroad and are lenders in the Eurobond markets. What they cannot do under current law is curiously incongruous with what they can do. For example, a bank may purchase agency securities issued by a third party, but it may not underwrite that third-party's CMO or REMIC backed by the very same agency securities. A bank may purchase whole mortgage loans from an originator, then issue and underwrite its own security backed by those mortgages, but if the originator itself issued the identical private security backed by those same mortgages, then the bank could not underwrite it.

Any time a bank purchases mortgages or a private MBS for portfolio, assumes the credit and market risk for a period of time, and subsequently sells the loans, it also sustains the fundamental risk of underwriting an MBS -- that is, the credit risk of the underlying mortgages. Subsequent securitization involves only marginal market risk by the underwriter, who hedges the security and sells the asset at no or very slight risk.

Public Benefits

NAHB firmly believes that the entry of banking institutions into private mortgage securities underwriting would produce public benefits that far outweigh possible adverse effects. These public benefits include increased competition and increased efficiency, the creation of value in the market, and the development of a strong private secondary market for mortgage securities.

Virtually all mortgage-backed securities are underwritten by a handful of investment banking firms. The rapid and remarkable growth of private securities during the past three years has only concentrated this activity further. The underwriting market for mortgage-related securities is exceptionally concentrated. In 1986, 2 firms had 58% of the market share for mortgage and asset-backed debt issues (the latter a negligible proportion). Although this share had declined from 68% in 1985, the same top ten firms increased their share from 94% to 96% of the market from 1985 to 1986 (Table 3). These market shares held fairly steady while the volume of the total market skyrocketed from $21 billion in 1985 to $67 billion in 1986.

By contrast, the underwriting market for tax-exempt general obligation bonds, a part of the larger municipal market and one in which banking organizations currently participate, is highly unconcentrated. In 1986, only 4 participants in the general obligation market had shares over 5% and the largest share was only 10% (Table 4).

NAHB believes that increased competition in this market is needed very much. We believe it would reduce underwriting and trading fees; improve access to capital markets for small mortgage lenders and builders; enable banking institutions to provide more services for their builder customers; attract new investors; enhance development of innovative mortgage security products; and strengthen credit enhancement and pool protection services. NAHB wishes to note also that the competitive issue is also integral to the ability of the American banking system to hold its own in an emerging system of global financial positions.

NAHB also believes that increased competition will contribute to greater product quality and product value, which are consistent with the safety and soundness of the banking industry. The ability of BHCs to underwrite and deal in MBSs will create value for both lenders and investors by generating liquidity as well as direct and indirect opportunities for BHCs to increase earnings and to provide better services to customers.

The Association has been concerned by ongoing initiatives of the current Administration that focus on reducing the role of the public secondary market agencies (GNMA, FNMA and FHLMC) in the capital markets. These initiatives and proposals include user fees on agency issues, privatization of FNMA and FHLMC, lowering the agencies' loan purchase limits, and limiting FHLMC's activity level. The Administration's efforts are clearly aimed at making the public agencies less competitive, and these initiatives underscore the need for more and stronger entrants into the private mortgage securities market.

Safeguards on Risk & Conflicts of Interest

As with any product or service offered by banking institutions, NAHB is concerned abut potential risks as well as abuses involving conflicts of interest and illegal tie-ins. NAHB does not believe that underwriting and dealing in mortgage-related securities entails undue risk or potential for conflicts of interest to the banking organization.

NAHB believes that the primary safeguard for BHCs underwriting MBS is the relatively low risk of this activity. The credit risk of underwriting an MBS differs fundamentally from underwriting other types of equity and debt securities such as stocks and corporate bonds. In the latter case, the issuer's payments on the obligations are derived from its earnings; thus the issuer's credit quality in terms of the earnings, liquidity and profitability is paramount in assessing risk. In an MBS or other asset-backed security, however, the issuer's payments of principal and interest to the investor derive from the cash flow of principal and interest payments on the underlying mortgages. The issuer's credit quality is secondary to the credit quality of the collateral, and in many cases is not even considered a factor in rating an MBS. Thus, the assessment and control of risk in underwriting MBS is the same as that in purchasing mortgages and MBS, which banking organizations routinely do. For much the same reasons, the market risk of underwriting MBS is not substantially different from that entailed in holding mortgages and MBS in portfolio; in managing a mortgage pipeline in preparation for pooling a security; or in underwriting a bank's own security issue.

Finally, protections against potential conflicts of interest and illegal tie-ins are adequately provided in the Bank Holding Company Act and in Sections 23A and 23B of the Federal Reserve Act. These provide for "arm's-length" transactions between affiliates that must be consistent with standards for transactions with nonaffiliated parties. To this end, NAHB approves of such controls as limits on buying and lending by affiliates during the underwriting period and extensive disclosures to customers about affiliate transactions.

MBS Provisions in S. 1886

NAHB has concerns, however, about two provisions specifically on mortgage-backed securities underwriting activities, that we do not believe should be contained in legislation. The first prohibits a securities affiliate from underwriting mortgage securities issued by or backed by mortgages originated by the affiliated bank unless the securities are rated by a national ratings service. The second is the prohibition on the bank underwriting MBS it issues. We believe that these conditions are not necessary in order to prevent conflicts of interest and risk where regulatory disclosures and industry standards can provide adequate safeguards. Furthermore, such limitations are likely to impede the achievement of the goals of this legislation to increase efficiencies, to increase competition, and to lower costs.

As desirable as ratings on securities are, there are nevertheless many situations in which high quality securities are not, in fact, rated. Currently, a significant number of securities backed by jumbo and other nonconforming mortgages are not rated, and securities backed by ARMs are increasingly not being rated. Many issues are deliberately structured so as to avoid the need for and cost of obtaining a rating.

We do not believe banks and mortgage affiliates should be deprived of the benefits of efficiency and low cost of affiliate underwriting in their participation in this portion of the market. In our opinion, the securities affiliate should be able to underwrite affiliate-related MBS that are eligible to be rated -- that is, they meet the ratings requirements and could be rated -- in addition to these that are rated. Another possibility would be to use the Comptroller of the Currency's criteria of "investment grade" securities; that is, eligible for purchase or holding by a national bank on the basis of quality and marketability.

NAHB is especially concerned about prohibiting a bank or insured institution from selling or underwriting securities backed by or representing an interest in mortgages or other obligations originated or purchased by the bank or its affiliates.

Particularly with respect to the bank underwriting securities related to its own portfolio of mortgage loans, we must concur with, and ask Congress to respect the OCC's legal determination, that a bank may sell its assets, regardless of whether they are whole loans, participations, securities, or newly issued securities backed by those assets. This legislation does not prohibit a bank from continuing to underwrite MBS guaranteed by a federal agency. At the same time, Mr. Proxmire's bill appropriately authorizes national banks to directly underwrite mortgage revenue bonds. Similarly, NAHB does not believe a bank should be prohibited from underwriting its own private MBS.

Amending these provisions would facilitate and enhance banks and BHC efforts to provide mortgage capital at an affordable cost to America's homebuyers.

Conclusion

In conclusion, we would like to reaffirm our support for financial institutions to underwrite and deal in mortgage-backed securities and revenue bonds; stress our strong opposition to direct investment in real estate for thrifts, banks and bank holding companies; and encourage a step-by-step approach to the adoption of changes in the financial services industry.

We are not experts on all aspects of how the financial services industry should be restructured, and, to date, NAHB has not adopted formal policy on all of the various legislative alternatives which are currently pending before the Committee. However, it seems that all of the bills, S. 1886, S. 1891, and S. 1905, go too far and move too quickly towards deregulating the industry. We would feel more comfortable with the modest powers approach taken by this Committee and the Senate in 1984 when they authorized four investment powers which we felt were consistent with the safety and soundness of the banking and thrift systems. While S. 1886 probably comes closest to that approach we nonetheless believe it is too broad in the new authority it allows. If that legislation were to proceed, we would recommend that a specific prohibition on direct investment in real estate be included in the bill.

Thank you for the opportunity to testify on this important subject.

Table 1. Funds Raised in U.S. Credit Markets ($ in billions)

Type of Security	Calendar Year 1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
U.S. Treasury Securities	$57.6	$55.1	$38.8	$79.8	$87.8	$162.1	$186.7	$199.0	$223.7	$214.7
Corporate a/ Bonds	31.1	28.6	25.1	28.5	27.2	31.2	28.1	69.4	110.5	131.5
Mortgage Pools	20.5	13.6	23.1	19.2	15.0	49.5	66.4	44.4	79.9	159.0
Totals for 3 Security Types	109.2	97.3	87.0	127.5	130.0	242.8	281.2	312.8	414.1	505.2
Mortgage Pools as percent of:										
U.S. Treasury Securities	35.6%	24.7%	59.5%	24.1%	17.1%	30.5%	35.6%	22.3%	35.7%	74.1%
Corporate Bonds	65.9	47.6	92.0	67.4	55.1	158.7	236.3	64.0	72.3	120.9
Totals for 3 Security Types	18.8	14.0	26.6	15.1	11.5	20.4	23.6	14.2	19.3	31.5

a/ Private domestic financial and non-financial corporations

Sources: Federal Reserve Bulletins (various issues)

Table 2. Outstanding Debt ($ in billions)

Type of Security	End of Calendar Year 1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	Mar.31 1987
U.S. Treasury (Marketable debt)	$459.9	$487.5	$530.7	$623.2	$720.3	$861.5	$1050.9	$1247.4	$1437.7	$1619.0	$1635.7
Corporate a/ Bonds	317.4	346.2	373.5	411.0	446.2	480.0	505.5	571.1	664.2	NA	NA
Mortgage Pools	70.3	88.6	119.3	142.3	163.0	216.7	285.1	332.1	415.0	529.8	575.6
Totals for 3 Security Types	847.6	922.3	1023.5	1176.5	1329.5	1578.2	1841.5	2150.6	2516.9	NA	NA
All Mortgage Debt	(1023.4)	(1169.4)	(1326.8)	(1471.8)	(1583.3)	(1658.4)	(1827.6)	(2033.7)	(2266.9)	(2563.8)	(2622.4)
Mortgage Pools as percent of:											
U.S. Treasury (Marketable Debt)	15.3%	18.2%	22.5%	22.8%	22.6%	24.6%	27.1%	26.6%	28.9%	32.7%	35.2%
Corporate Bonds	22.1	25.6	31.9	34.6	36.5	45.1	56.4	58.2	62.5	NA	NA
Totals for 3 Security Types	8.3	9.6	11.7	12.1	12.3	13.7	15.5	15.4	16.5	NA	NA
All Mortgage Debt	6.9	7.6	9.0	9.7	10.3	13.1	15.6	16.3	18.3	20.7	21.9

a/ Private domestic non-financial corporations

Sources: Federal Reserve Bulletins (various issues)
Annual Statistical Digests of the Board of Governors, Federal Reserve System (various issues)
Treasury Bulletin, June 1987

Table 3. Underwriting Market Shares for Mortgage and Asset-Backed Debt, 1985 and 1986

	1986		1985				
	Amount ($ Millions)	% of Total	Amount (Millions)	% of Total	Increase in Volume 1985-86 (Millions)		% Share of Total Industry Increase
Industry Totals	$66,916.5	100.0	$20,958.7	100.0	$45,957.8	219.3%	100.0
First Boston	20,961.2	31.3	6,917.0	33.0	14,044.2	203.4	30.6
Salomon Brothers	17,787.1	26.6	7,412.5	35.4	10,374.6	140.0	22.6
Merrill Lynch Cap. Mkts.	7,592.3	11.3	1,194.2	5.7	6,398.1	535.8	13.9
Shearson Lehman Brothers	4,096.7	6.1	1,560.5	7.4	2,536.2	162.5	5.5
Morgan Stanley	3,804.5	5.7	322.7	1.5	3,481.8	1,079.0	7.6
Kidder, Peabody	3,095.4	4.6	369.7	1.8	2,725.7	737.3	5.9
Goldman, Sachs	2,590.4	3.9	298.5	1.4	2,291.9	767.8	5.0
Drexel Burnham Lambert	1,557.3	2.3	979.5	4.7	557.8	59.0	1.2
Prudential-Bache Securities	1,395.1	2.1	91.2	0.4	1,303.9	1,429.7	2.8
PaineWebber	1,211.2	1.8	544.5	2.6	666.7	122.4	1.5
Top 2	38,748.3	57.9	14,329.5	68.4	24,418.8	170.4	53.1
Top 5	54,241.8	81.1	17,406.9	83.1	36,834.9	211.6	80.1
Top 10	64,091.2	95.8	19,690.3	93.9	44,400.9	225.5	96.6

Source: Investment Dealers Digest, January 12, 1987.

Table 4. 1986 Market Shares of Top 10 Underwriters in Each Category (Full Credit to Lead Manager)

Underwriter Rank	Mortgage-Backed Debt	Bank-Eligible State and Local General Obligations*
1	31.3%	10.9%
2	26.6	9.4
3	11.3	7.2
4	6.1	6.1
5	5.7	4.7
6	4.6	4.5
7	3.9	4.1
8	2.3	4.0
9	2.1	3.0
10	1.8	2.6
Top 2	57.9	20.3
Top-5	81.1	38.3
Top 10	95.8	56.5

* Banking organizations compete in underwriting tax-exempt General Obligations which are part of the total municipal market. Four are in the top 10 in the general obligation market. The highest ranking bank in the total municipal market was 12th.

Source: Investment Dealers Digest, January 12, 1987

The CHAIRMAN. Thank you, Mr. Colton.

Mr. Googins.

STATEMENT OF ROBERT R. GOOGINS, EXECUTIVE VICE PRESIDENT, CONNECTICUT MUTUAL LIFE INSURANCE CO., TESTIFYING ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. GOOGINS. Thank you, Mr. Chairman.

My name is Robert R. Googins. I'm executive vice president of Connecticut Mutual Life Insurance Co., appearing here today on behalf of the American Council of Life Insurance, a trade association of insurance companies in the life insurance area that represent the vast majority of insurance in that area sold in this country.

I would normally preface my remarks by saying that it's an honor and a pleasure to appear here before you, and while the honor part of it is clear enough, my experience before Mr. St Germain in the House leads me to believe I ought to defer the pleasure part until the end of the question and answer period. [Laughter.]

You will hear here today a number of parochial views and ours will be one of those parochial views. Obviously, it is your difficult task to sort those out in terms of framing what national banking policy ought to be. We hope that our views will aid you in that quest.

Let me quickly come to the substance of our submitted printed testimony. I'm sure our views, as well as the others, will probably come as no surprise to you.

We are unable to support the bills that are being discussed today based upon our fundamental belief that prudence argues against the dismantling of the historic separation between banking and commerce.

We also do not share the view that recent events are not material in determining whether or not changes should be made at this particular time. Indeed, we believe that this historic separation contributed significantly to the weathering by the banks of the very traumatic events of "Black Monday."

Reflect upon what might have been the case had the banks during this period of time had all of the securities powers and other powers that the regulators would have given them had they had the free rein to do so. Public confidence is a very ephemeral thing and while we believe with respect to these bills, particularly S. 1886, that a noble effort has been made in this proposed legislation to create a so-called firewall between banking and the other activities, the public psyche really is governed by what it thinks the dangers are as distinguished from what they may actually be. So in that respect we question whether or not a firewell apparatus can be effective at all.

You need look back only a few years with respect to the experience of a number of States, particularly Maryland, and I think Community Savings & Loan was the institution concerned, where a subsidiary got into significant difficulty but the parent S&L itself was not in any trouble. But the public lined up at the tellers' windows to take out their deposits based upon their perception that the institution as a whole was in trouble.

Also you need only look to Continental's First Options experience to see what actually happens when the heat is turned up and business decisions must be made at a crucial period of time.

BANKS PROFITABILITY

One might be appropriately skeptical of the arguments that expanded powers are essential to increased profitability of banks. First, I think it was just yesterday's Washington Post that suggested that record earnings had been experienced during the third quarter of the year by the banking industry in general. Furthermore, the January issue of Forbes reporting on the results of the 5 years ending with the last completed full calendar year showed that the net profit margins for banks was better than for either the insurance or securities industries, and I know, since I'm going through the budget process in my own company right now, if banks think there are great profit margins to be had in insurance they are in for a bigger surprise than they think.

Furthermore, the Chairman of the FDIC has suggested that at least with respect to many of those banks that have failed it was not the absence of profit opportunity that was the problem, but more often it was the problem of mismanagement and sometimes even fraud and self-dealing in a number of those cases.

More importantly, even if banks need these powers to bolster profits with respect to their core business, one should not immediately jump to the conclusion that the additional earnings will be for the benefit of the consumer.

The evidence with respect to credit insurance and credit card interest rates certainly wouldn't seem to bear out that particular result.

More particularly, we are troubled with respect to S. 1886 that, notwithstanding the provisions of 4(c)(8) of the Bank Holding Company Act, that this particular bill, although it doesn't become immediately obvious on the surface, would indeed authorize banks to underwrite and sell variable annuities, variable life insurance, and guaranteed interest contracts which are frequently used to fund group annuities often sold in connection with pension plans. This results simply because these insurance instruments also are required to be registered as securities under the Federal securities laws. This is certainly in direct opposition to the enunciation of congressional intent earlier with respect to 4(c)(8) of the Bank Holding Company Act.

Earlier this year, we were asked and did support the Competitive Equality in Banking Act, even though it permanently closed the nonbank bank loophole and provided only a moratorium with respect to further expansion of banking powers during the moratorium period, including the use of the South Dakota loophole.

The ink was just beginning to dry on that document when the *Merchants National* decision was issued, which suggested that the Federal Reserve Board was perfectly willing at that time to sanctify the South Dakota loophole. We, of course, wanted that South Dakota loophole to be closed permanently while CEBA was under consideration. But in light of what we thought was a commitment to undertake an examination of all of these issues in connection with any subsequent legislation, we did support the moratorium.

We do in fact thank the Chairman and other members of the committee profusely for their participation in the *Merchants National* case and the filing of the amicus brief staying that particular order of the Federal Reserve Board, and we think your brief was particularly persuasive.

However, at this juncture, we feel that there's a serious omission in S. 1886 because it does not follow through on what we perceive to be the commitment that led us to support CEBA, to wit: permanently closing the South Dakota loophole. Indeed, we believe you have a very excellent mechanism for doing that with S. 706 that has been previously proposed by Senators Heinz and Dodd.

Unlike a number of other witnesses that are going to be discussing this issue today, we think that one thing is important. After you get through sifting out all of our parochial views, it is imperative for the Congress once again to reach out and grab ahold of what national banking policy ought to be, and that it ought not to be left to the regulators.

Indeed, in that sense, we believe that S. 706 ought to be incorporated in any legislation that moves forward, because if the moratorium is left to expire considering that the nonbank bank loophole has been permanently closed, we believe that our industry will be particularly disadvantaged. Further, it would permit banking regulators to exercise unfettered discretion in the granting of new powers to banks. We are looking forward to the deliberations of this body and its outcome.

Thank you very much.

[The complete prepared statement of Robert R. Googins follows:]

STATEMENT OF THE
AMERICAN COUNCIL OF LIFE INSURANCE

Before the

COMMITTEE

on

BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

S. 1886, THE FINANCIAL MODERNIZATION ACT OF 1987,

S. 1891, THE FINANCIAL SERVICES OVERSIGHT ACT,

and

S. 1905, THE DEPOSITORY INSTITUTION AFFILIATION ACT

December 9, 1987

Statement Made By:

Robert R. Googins
Executive Vice President
Connecticut Mutual Life
Insurance Company

Mr. Chairman and members of the Committee, my name is Robert R. Googins, and I am Executive Vice President of Connecticut Mutual Life Insurance Company. I am appearing today on behalf of the American Council of Life Insurance. The ACLI has 646 member life insurance companies which account for approximately 94% of the life in force in the United States and over 97% of the insured pension business.

We appreciate this opportunity to express our views on S. 1886, the Financial Modernization Act of 1987, S. 1891, the Financial Services Oversight Act, S. 1905, the Depository Institution Affiliation Act, and other matters bearing on the evolving structure of this country's financial services marketplace.

S. 1886

General Observations

Mr. Chairman, although we have given your bill, the Financial Modernization Act of 1987, careful consideration, we are unable to support it. Our position reflects a fundamental belief that prudence argues against dismantling the historic separation between banking and other forms of commerce.

Your bill reflects much thoughtful consideration of the issues, and addresses many of the concerns we have articulated in the past regarding the proposition of expanded bank powers. These concerns include concentration of economic power, potential drains on bank capital and conflicts of interest. While the regulatory structure advanced in S. 1886 attempts to address these potential adversities, we believe that the bill's provisions would not prove effective in all instances.

Banks are and must remain favored financial institutions governed by a unique regulatory structure. They are at the heart of our payments system, and both public and private interests demand that the banking system remains as stable as possible. Proposals for deregulation always give rise to a basic conundrum. Can you fashion a regulatory structure that accommodates business from an operational standpoint without sacrificing regulatory constraints to the degree that institutional safety and soundness and other public interests are jeopardized? Put differently, does "adequate" regulation in a deregulated marketplace necessarily eliminate the incentive for banks to diversify into other businesses? If the choices are to impose inadequate constraints on banks and other providers of financial services in order that they can easily compete with one another or to continue the prudent separation of banking and other forms of commerce, we strongly endorse the latter.

The events of and following "Black Monday" give harsh testimony to the economic consequences that can befall this nation's financial institutions, even given existing safeguards imposed in the post-depression environment. One can only wonder what the domestic consequences of that crash would have been had banks in this country been interrelated with the securities industry to the degree that they and some of their regulators feel is desirable.

It is likely that minor adversities in the marketplace can be absorbed without severe disruption under any responsible regulatory structure, including one that provides banks with new nonbanking powers. However, a truly effective bank regulatory system must be designed to absorb the exceptional or worst-case situations. It is the Black Mondays against which the system must protect, not the relative calm that prevailed for 58 years.

One has only to look at the difficulties of Continental Illinois National Bank and its subsidiary, First Options of Chicago, Inc., to see the dangers created by these types of affiliations. Members of this Committee have undoubtedly heard many opinions concerning what the First Options adventure means, but in our view several points warrant mention.

First, some federal bank regulators have suggested that the First Options experience demonstrates that "the system works." While this is not an entirely surprising statement given the perspective on deregulation of these regulators, even a cursory analysis of the facts leaves one skeptical of the validity of that statement. Consider that the "system" being referred to is the present system under which banks remain largely separated from securities operations. It was not a system accommodating widespread bank securities activity. Consider also that Continental Illinois National Bank is subject to perhaps the highest level of federal bank regulatory scrutiny of any financial institution in this country. Would the impermissible loan even have been detected had it been made by a bank subject to a normal level of regulatory scrutiny? Or detected before the bank became insolvent? Just as troubling as the fact that the Continental loan was even made under these circumstances is the resulting "sanction" administered by the Comptroller of the Currency - a consent order "enforcing" by reiteration the loan limitation that the bank had just violated. At most, a slap on the wrist. Looking at this precedent, what action would a similarly situated bank take in the future? The answer to that question is both obvious and disturbing. What the First Options situation demonstrates is the practical difficulty of insulating a bank from its nonbanking enterprises.

Simply moving the nonbanking activity around within the holding company structure provides little real insulation, particularly in extreme circumstances where experience shows us that the desire of managers to keep a subsidiary operation from going belly up will often take precedence over legal constraints on intra-company transfers. The fact that none of the legislation before this Committee offers a realistic solution to this problem, despite the best efforts of the drafters, is indicative of the thorniness of the issue.

We are also uneasy with the notion underlying the banks' argument for new powers that unless these powers are bestowed, they, despite their favored competitive position, can not remain viable institutions. Yet, Mr. Seidman recently observed that fully a third of bank failures (which will reach a post-Depression record for the fourth consecutive year) are caused by fraud and self-dealing. The other two-thirds are generally acknowledged to be the result of mismanagement. In short, these failures are not occurring because banks are lacking expanded powers; they are occurring because banks are not successfully managing the activities they already have the power to conduct. If a bank can not be profitable being a bank, than incumbent management should be removed. Common sense tells us that the solution to ineffective management is not to give managers wider latitude to attempt in less familiar areas what they have already demonstrated they can not do in familiar territory. Many banks, both large and small are profitable today. Others are not. This is no different from the situation in the insurance, securities or real estate businesses. When you cut through the rhetoric and focus on the facts, the "new powers or die" argument is devoid of substance.

A final general comment concerns consumers. Every bill facilitating bank deregulation promises benefits to the consumer, primarily through enhanced competition and lower prices. These are laudable goals, but it is disingenuous to imply that these consumer benefits are assured if only banks can gain new powers. Consider once again the facts on this point. Entry barriers to insurance and securities are quite low. Any entity except a bank, and in some instances thrifts, can own an insurance company or securities firm. Anyone. Retailers, manufacturers, venture capitalists, bakers or individuals. Common sense and a rudimentary understanding of economics tells you that if everyone under the sun can get into these businesses except banks, the mere act of allowing banks to enter such businesses will not have a meaningful effect on competition. In addition, empirical evidence demonstrates that both the securities and insurance businesses are highly competitive. As for insurance, we have frequently pointed out that there have been substantial numbers of new companies entering the business; concentration and profits are low relative to other industries; new and innovative products continue to be developed; and, most importantly, competitive pressures have seen to it that cost reductions occasioned by technological advances and increases in mortality and investment income have been passed along to consumers. The cost of basic insurance protection has decreased more than 20% since 1960 in real dollar terms.

Perhaps even more significant is the profit motivation that is really driving banks' efforts to gain new powers. Banks, like insurers or stock brokers, are in business to make money. They do not exist to perform charitable deeds for the consuming public. They endeavor to market products and services that consumers will buy, but those products are priced purely by the laws of supply and demand. In light of their profit motivation, even if banks could offer insurance products more cheaply, which is highly doubtful, could they really be expected to do so? Why would they? One has only to look at some existing bank practices to realize that the balance sheet and not the interests of consumers will control. Are banks presently giving the consumer a break on credit insurance, the one type of insurance they are generally permitted to sell? How about on credit card interest rates or checking account service charges or funds availability? The answer to all these questions is an emphatic "no." The point is not to criticize banks for these practices. They probably make good sense from a business standpoint. We just wish to point out that the consumer benefit arguments bankers haul out time after time are empty rhetoric. If banks wanted to offer bargains to the consumer, they could do so right now with products and services they presently offer.

Specific Comments

While the ACLI must oppose S. 1886 because of our basic position on the separation of banking and commerce, we nevertheless feel it would be productive to offer several specific comments on the provisions of the bill with which we are particularly concerned. The most important of our concerns is the fact that the bill authorizes bank securities affiliates and national banks to underwrite and to sell various types of insurance products. The insurance products involved are significant. Consequently, the proposition that banks should be empowered to underwrite and to sell these products is extremely objectionable from our perspective.

The insurance "authorizations" of S. 1886 appear in Sections 102 and 108. Section 102 provides in part that the Bank Holding Company Act is amended by adding a new paragraph 4(c)(15)(A) which authorizes banks, through securities affiliates, to underwrite, distribute or deal "in securities of any type." This reference to "securities of any type" encompasses all variable annuity and variable life insurance contracts, since these insurance products are also categorized as "securities" which must be registered under the Securities Act of 1933. Section 102 also covers insurance contracts that are "exempt securities" under Section 3(a)(2) of the Securities Act of 1933 (i.e., securities that need not be registered, but which are nevertheless subject to SEC anti-fraud jurisdiction). Included in this latter category are contracts, most of which are forms of guaranteed interest contracts, usually in the form of group annuities, used in the corporate qualified pension market.

Section 108 authorizes national banks to, among other things, distribute "securities issued by investment companies" as that term is defined in Section 3 of the Investment Company Act of 1940. This provision is applicable if the bank does not have a securities affiliate. Separate accounts established by life insurance companies to fund variable annuity and variable life insurance contracts, are, almost without exception, "investment companies" within the meaning of Section 3 of the 1940 Act. Consequently, this provision empowers national banks that do not have securities affiliates to act as agent in the sale of variable annuity and variable life insurance products.

At best, Sections 102 and 108 raise questions concerning the interplay of the bill's securities authorizations and the insurance limitations presently contained in Section 4(c)(8) of the Bank Holding Company Act. These sections could be interpreted, however, to create an insurance loophole for many bank holding companies and national banks through which they could engage in the business of insurance. This loophole scenario would undoubtedly be endorsed by banks and their regulators.

The ACLI strongly opposes the inclusion of insurance in S. 1886. This opposition is predicated not only on our basic policy position endorsing the present separation between banking and insurance, but also on specific concerns with conflicts of interest and safety and soundness. For example, permitting national banks to act directly as agent in the sale of variable contracts without any consideration being given to the dramatically enhanced opportunities for exercising credit leverage is totally inappropriate. Permitting securities affiliates to underwrite variable annuities, variable life insurance and guaranteed interest contracts without any understanding of attendant risks is equally ill-advised.

Underwriting variable life insurance presents a good example of the risks to safety and soundness that are involved in the insurance business. In recent years, the popularity of variable life insurance has increased dramatically, and for many companies this product represents a significant percentage of their new premium business. As of year end in 1986, there were over 1 million variable life insurance policies issued representing in excess of $64 billion of insurance in force.

You might think that insurers would be delighted to write new variable life insurance business just as fast as they could. There are, however, complicating factors. Any company placing variable life insurance on its books at a significant rate experiences tremendous strains on its surplus. Surplus strain associated with a successful product highlights a risk that is unfamiliar to banks and would, without question, potentially jeopardize their capital position.

This point can be highlighted by an example of 10 bank depositors and 10 variable life insurance purchasers. If 10 individuals approached a bank and each placed $10,000 in a demand deposit account, the bank would, without question, be pleased. The $100,000 dollars in deposits would be invested, and, if invested prudently, would provide a profit to the bank. If one of the depositors was struck and killed by a car shortly after leaving the bank, the return of the $10,000 deposit to the depositors estate would present little disruption, since the full amount of the bank's obligation to the depositor was originally deposited with the bank.

Quite a different situation occurs in the case of the 10 individuals purchasing variable life insurance policies for a premium of $10,000. For that $10,000 in premium, each new policyholder has purchased life insurance with a face amount of $1,500,000. The insurer has the same $100,000 as the bank, but if one of the insurance purchasers dies in an automobile accident shortly after issuance of the policy, the insurance company would be out $1,400,000. Together the 10 policy holders have created for the insurer a contingent liability of $15,000,000. Of course, the insurance statutes of each state require the insurer to set aside reserves against the liability created by virtue of the insurer's promise to pay $15,000,000 in death benefits. As premiums continue to be received, this reserve liability will diminish, but in the early years of a policy, it is significant. Thus, the insurance company that has just put $15 million in variable life insurance on its books must immediately draw upon its accumulated surplus to meet its sharply increased statutory reserve requirements. As ironic as it may seem, tremendous success in the marketplace generally means that a life insurance company or its parent will encounter extremely significant economic strains. And, too, the life insurance company incurs the risk that its underwriting standards have been inadequate and that an unusually high number of those ten new policyholders will die. These mortality risks, which are also significant, are another aspect of the life insurance business with which banks are unfamiliar.

The point of this example is to indicate that there are significant and unique risks associated with the underwriting of life insurance products. The impact these risks could have on banks has received little, if any, consideration by this Committee.

Another fundamental drawback of S. 1886 is that the way in which it grants securities powers to banks creates significant and unacceptable competitive inequities for other providers of financial services. For example, most securities firms, with the exception of some small regional operations, are diversified firms that have various commercial or financial affiliations, including real estate development subsidiaries or subsidiaries conducting insurance activities beyond those permitted for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act. Affiliations of this nature have always been lawful. Most of these affiliations would be prohibited under S. 1886, with the result that these securities firms would be unable to take advantage of the legislation to gain a banking capability. In contrast, banks would generally be free to enter the securities business and compete directly with these firms. As a practical matter, the powers authorization in S. 1886 is a one-way street in favor of banks.

On a more technical level, the bill poses a problem for insurers controlling insured nonbank banks grandfathered under CEBA. Under CEBA, these insurers are not subject to the Bank Holding Company Act, and indeed could not comply with BHCA restrictions on nonbanking activities. Yet, if such an insurer wished to add, for example, an additional broker/dealer subsidiary, an otherwise permissible act, it would arguably be unable to do so. Section 107(a)(3)(A) prohibits any insured bank from affiliating with a securities firm except as provided in Section 4(c)(15)(A). Affiliations authorized under that Section cannot be entered into, however, unless a Section 4, Bank Holding Company Act application is made and approved by the Federal Reserve Board. How can an entity not subject to the Bank Holding Company Act by definition gain approval for an otherwise lawful affiliation if the only avenue for approval is compliance with provisions of the Bank Holding Company Act?

Even though the ACLI does not support the concept of expanded bank powers, we certainly advocate competitive equality in the event any deregulation proposals are enacted, and we urge that the concept of competitive equality be given further consideration by the Committee in the context of S. 1886.

S. 1891

Fundamental differences in policy also lead us to oppose S. 1891, the Financial Services Oversight Act introduced by Senator Wirth and Senator Graham. Beyond our general objections, we offer the following specific comments.

Because the business of insurance is regulated at the state level, it has never fared particularly well at the hands of commissions or other groups that have a distinct federal orientation. Two examples that immediately come to mind are the treatment of insurance concerns by the Bush Task Group on Financial Services Restructuring and the President's National Commission for Review of Antitrust Laws and Procedures. Thus, there is considerable skepticism within the insurance community that the Financial Services Oversight Commission, notwithstanding its inclusion of the President of the National Association of Insurance Commissioners, would serve the best interests of our business. It is likely that a federal perspective, and probably a federal bank regulatory perspective, would dominate the deliberations of this group.

One of the objectives of the Commission and S. 1891 generally is to embrace the notion of "functional regulation" as a means of addressing satisfactorily issues such as institutional safety and soundness and the avoidance of regulatory conflict. At first blush, functional regulation seems to make good sense. In many business affiliations where there are distinct corporate entities and distinct products, it may in fact prove workable. However, functional regulation loses its effectiveness in a truly integrated financial services environment where single products involving multiple functions are issued by single entities. The insurance industry has grappled with this problem for many years in the context of variable life insurance and variable annuities. These contracts have attributes of both insurance and securities. Variable contracts are comprehensively regulated by both the state insurance departments and the Securities and Exchange Commission. Since these products are issued by a single corporate entity, The **Chairman**. Thank you, Mr. Googins.

Mr. Flynn.

STATEMENT OF NORMAN D. FLYNN, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. **Flynn**. Thank you, Mr. Chairman.

My name is Norman D. Flynn from Madison, WI. I am the first vice president of the National Association of Realtors, which has nearly 800,000 members throughout the United States.

In addition to that, I'm a former chairman of the board of the Independence Bank of Madison which had been the Metropolitan Bank of Madison and I served in that capacity for 8 years and for 2 years on the holding company of the Independence Bank in Waukesha. So I have some background in the banking industry as well as in the real estate industry.

I want to thank you, Mr. Chairman and members of this committee, for allowing us to submit written testimony and to provide this oral testimony. Rather than review what is in the written testimony, I'd like to make four or five points outside of that, that I think might be important for the deliberations on this issue.

DIVERSIFICATION

First, I think that for the banks and the financial institutions to get into other businesses right now might be unnecessary diversification. I look at the Baldwin Corp., who decided businesswise that diversification was the primary way that they would be profitable only to discover after 5 or 7 years of that activity that they had to unbundle it so that they could survive as a company.

I believe that financial institutions who are looking to improve their profitability simply by using diversification as that mechanism may be taking a philosophical policy which is not prudent and not in the best interest of the financial community.

Second, if they are going to diversify, look for businesses to offset profits, they ought to get in businesses that aren't necessarily affected cyclically like their own business. The real estate industry is extremely interest sensitive and when interest rates go up or are disruptive, our business goes down. So when banks are in the interest crunch, they are having financial problems and loss of profitability and their subsidiaries will have comparable loss of profitability at exactly the same time.

So rather than ensure their safety and integrity and profitability, it occurs to us that they would be getting into businesses which would be equally cyclical and equally unprofitable at the same time.

The next point I'd like to make is that by getting into subsidiary businesses it might be difficult to regulate. I had the privilege as chairman of the board of our bank to work with auditors and found them to be both intelligent and of great assistance to us in operating the bank. I had a great deal of additional good faith and good feeling about what they did for us and they assisted us early in my banking experience in turning a bank around and making it work and making it profitable.

However, I don't believe they are equipped necessarily to look at the subsidiary activities of this proposed intrusion into or at least involvement into normally nonfinancial activities, that they would have that same kind of business or same kind of ability.

First, the subsidiaries would be outside of the central bank and the banking functions and, second, it would be outside of their expertise.

The next point that I'd like to make is that real estate investment and development is a sophisticated business and while banks would like to believe they are sophisticated in their analysis, I believe it's a sophistication that the current banking industry does not have. In fact, while it might appear to them that it's easy to get into this business and make it profitable, I think that on balance over the years the financial community has been a joint venturer with the developers and the investment community providing both credit on a conservative basis and the joint venture between the conservative bank and the aggressive optimistic developer has resulted in many instances in good sound development. When the enthusiasm of the developer or when the bank and the developer are one and the same person through subsidiary relationships, I believe the overdevelopment that we see in some certain parts of the country right now would be rampant throughout the country and jeopardize the integrity of not only the new product that they would put on the line but the existing product that's there.

Last, the brokerage community and the brokerage business is not as profitable as most people would have you believe. I am not here to argue that being in my business is not intelligent. However, in 1978, which is considered the bellwether year of real estate activity when we had more home sales and more transactions than any other single year, 25 percent of the real estate companies in the United States reported that they lost capital. As we survey our brokers throughout the country, we find between 25 and 40 percent of them experienced shortfalls or negative cash flows in their operation of their businesses. That's particularly true when you have the high interest rates of 1981, 1982, and 1983.

The realtors are not against deregulation per se. We are concerned about the safety and soundness of the financial institutions. They provide the credit as joint venturers to assist us in doing our business of providing housing for America and investments and development opportunities for businesses. We feel that the relationships that we've had with them is an appropriate one.

We thank you, Mr. Chairman, for your support of the moratorium on allowing financial institutions to engage in the real estate business. We encourage you to continue that activity and permenantly decide that it's not an appropriate business for the lending institutions to be involved in.

I would be pleased to answer any questions that you may have.

[The complete prepared statement of Norman D. Flynn follows:]

functional regulation in this context equates with dual regulation of these products. If it ever became permissible for a variable insurance product to be funded by a bank account, three functions would be involved and federal or state bank regulatory authorities would undoubtedly demand a regulatory role with respect to that single product.

In this environment, regulatory conflicts over "turf" frequently occur. Also, regulators are forced to deal with business practices and concepts that are unfamiliar to them (e.g., the SEC constantly struggles to comprehend the pure insurance elements of a variable contract operation). The ultimate loser in this arrangement is the issuing financial institution (and its customers) which, instead of some logical form of regulation, ends up with the burdens and inefficiencies of multiple regulators.

Asking the insurance industry to support S. 1891 is, to a great extent, asking us to accept a pig in a poke. While the repeal of the insurance prohibitions of Section 4(c)(8) of the Bank Holding Company Act indicate quite clearly that banks will be permitted to enter the insurance business, reciprocal authority for insurers and others to enter the banking business is apparently left largely to the discretion of the Commission. Clearly the Commission would have the ability to deny such authority to insurers thus creating severe competitive inequities. Any industry must oppose a bill that may ultimately result in its having a distinct competitive disadvantage.

[illegible]

Finally, we point out that the bill has certain discriminatory aspects that must be opposed by the insurance industry. First, it does not accommodate the unique circumstances of mutual life insurance companies and therefore creates inequalities between mutual insurers and all other providers of financial services, including stock insurance companies. Second, the bill discriminates against any insurer that already has an upstream or downstream commercial affiliation of any sort. These affiliations are quite common, and we have not seen any convincing explanation of why a line of demarcation must be drawn between finance and commerce. Indeed, given the uniqueness of banks, the only rational distinctions appear to be along the traditional lines of separating banking and other forms of commerce.

[illegible]

S. 1905

The ACLI is also fundamentally opposed to S. 1905, the Depository Institution Affiliation Act introduced by Senators D'Amato and Cranston. Again, we offer several observations on this legislation.

S. 1905 present perhaps the clearest example of what results when you attempt to construct a regulatory structure that is accommodating to diverse financial institutions from an operational standpoint. It is also true that under this bill all business entities could control a depository institution through a depository institution holding company. It is true that this new form of holding company eliminates the discriminatory barriers effecting mutual life insurance companies that would otherwise exist as noted in our comments on S. 1891. From this perspective, one can argue that competing institutions are well-served, since the elusive "level playing field" has been achieved. Nevertheless, as responsible legislators, you must consider the price that has been paid to achieve these goals through the sacrifice of adequate regulatory controls.

Despite the explanatory materials accompanying this legislation, there will not be a greater degree of regulation of interrelated producers of financial services. Indeed, the aspect of this legislation that gives it its operational appeal is its provision for rather superficial regulation of a depository institution holding company. Superficial regulation at the depository institution holding company level is an essential assumption for those supporting this bill, since holding companies that are operating companies (e.g., life insurance companies) simply could not function if they were regulated strictly and comprehensively as provided under the Bank Holding Company Act.

Perhaps the most disturbing example of relaxed regulation in S. 1905 is in the area of affiliate transactions. While the bill does extend Sections 23A and 23B of the Federal Reserve Act to the new types of affiliations that would exist in a depository institution holding company structure, it goes on to provide that appropriate federal regulators may exempt any insured bank or insured institution in depository institution holding company form from any prohibitions or limitations on affiliate transactions if the regulator deems this action "reasonable and not inconsistent with the purposes of this Act and in the public interest." Additionally, the bill expressly amends Section 23A of the Federal Reserve Act by liberalizing bank extensions of credit to affiliates if the bank approves such extensions in the same manner it approves loans or extensions of credit to non-affiliates. Consider that the loan Continental Illinois National Bank made to First Options of Chicago would probably be approved under this liberalized regulatory structure. One must question whether this environment provides adequate safeguards to bank safety and soundness.

It is interesting to note that even the Report of the House Committee on Government Operations entitled Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework of Safe and Sound Banking, concludes that the limits imposed by Sections 23A and 23B are insufficient as presently drafted to insulate the operations of a banking subsidiary from other parts of the holding company complex. Specifically, the Report states that:

> Interaffiliate loans within |Section 23A- scale limits could still be substantial if the bank is large and could therefore be used to convey effective deposit insurance protection to affairs of smaller affiliates, thereby encouraging excessive risktaking by these affiliates and

> contributing to unfair competition in the markets |they- serve .... |Also- official sanction for interaffiliate lending, even when restricted in magnitude, establishes a tolerant attitude among both regulators and bank management that facilitates abuse in the event of pressure to assist affiliate.

S. 1905 also has one of the most extensive provisions on preemption of state and federal law that we have every encountered. Every state insurance law or regulation that in any conceivable way interferes with what banks would like to do in an integrated financial services marketplace would be preempted. Moreover, any federal law or regulation that expressly or impliedly conflicts with banks' view of deregulation would be preempted. In a sense, banks' support for extensive preemption of state law is ironic, since those same banks criticized the insurance industry for daring to interfere with the states' role in the dual banking system in connection with our efforts to close the state bank loophole. We hasten to point out, however, that our proposal for closing that loophole as set forth in S. 706 would have absolutely no effect whatsoever on any state law, and certainly would not preempt any of those laws, even South Dakota's.

Perhaps the most disappointing aspect of S. 1905 is its purported "insulation" of depository institutions from their nonbanking affiliates. Materials associated with this legislation suggest that it is a milestone as far as successfully and effectively insulating depository institutions from their nonbanking affiliates. This rhetoric suggests that all significant nonbanking activities will be required to be housed in separate affiliates. Such is not the case.

For example, the bill does not require that any insurance agency activities be conducted separately from the bank. More importantly, there is a large loophole in the bill's separate affiliate requirement. The bill provides that nonbanking activities must be conducted in a separate affiliate unless the activity is authorized for a national bank under 12 U.S.C. <92a. This provision of the National Bank Act is administered by the Comptroller of the Currency, and those of you that have followed the Comptroller's latest efforts to grant banks broadened powers are aware of the elasticity the Comptroller has found in Section 92. For example, you would logically expect that S. 1905 would require that the underwriting of municipal bond guarantee insurance or the underwriting collateralized mortgage obligations would be the types of insurance and securities activities that would have to be conducted in a separate securities or insurance affiliate. In point of fact, that would not be the case, since the Comptroller in a stroke of the pen has already converted these activities from insurance and securities underwriting into the business of "banking" which is therefore permissible under Section 92. In sum, the Comptroller would be given sole discretion to determine what activities need not be conducted in separate affiliates.

Finally, we reiterate the same concerns with superregulators that we expressed in connection with the similar concept outlined in S. 1891. Our skepticism is magnified in this instance given the slightly different composition of the National Financial Services Committee. This group is an exclusive federal fraternity. Even though insurers are intended to be major participants in depository institution holding companies, and in fact could be the predominant and controlling entities in such holding companies, state insurance regulators are not included on the Commission. In a magnanimous gesture, the bill would permit the Committee to "consult" with state regulators and, if appropriate, to meet with them. In this, the insurance industry takes little comfort. Without question, the regulator envisioned by this proposal would be heavily biased in favor of banks and likely disinclined to endorse a regulatory environment satisfactory to the insurance business.

The bill also provides that federal regulators would have the authority to examine the books, records and affairs or require reports from any affiliate (e.g., an insurance company) of an insured bank or insured institution controlled by a depository institution holding company in order to insure compliance with federal regulatory objectives. There is no reciprocal authority permitting state insurance regulators to review the affairs of affiliates of insurance companies (e.g., banks) for purposes of determining the adequacy of the insurer's solvency. Harking back to Mr. Seidman's explanation of the cause of most recent bank failures, this lack of reciprocity can not be countenanced.

The Insurance Perspective

As noted above, the principal reason for the life insurance industry's opposition to S. 1886, S. 1891 and S. 1905 is that each proposal would to a greater or lesser degree end the separation between banking and commerce. This separation was not established casually or by accident. It was the carefully conceived product of bitter experience and was seen as the best way to insulate the banking system both from inherent conflicts of interest and economic trauma in the nonbanking sector. We believe that this separation has worked extremely well and should be retained.

Earlier this year, as part of the Competitive Equality Banking Act of 1987 (CEBA), this Committee asked the insurance industry to support the closing of the nonbank bank loophole on a permanent basis in exchange for a moratorium on new bank powers. We did not want a moratorium; we felt that in view of the closure of the nonbank bank loophole fundamental equity demanded permanent legislation to close the South Dakota loophole and other loopholes by which banks have been entering the insurance business.

We supported the CEBA moratorium, however, accepting the promise of this Committee that there would be an opportunity to address the full scope of issues in the financial services area, including the exploitation of loopholes by banks with the assistance of their compliant regulators. This hearing provides us an opportunity to restate our concerns, and for that we are very appreciative.

It is essential that all perspectives on financial service deregulation be carefully considered, before any proposal be adopted. Three points deserve mention:

1) Congress must not lose sight of the fundamental question of whether it is appropriate and in the public interest to deregulate; 2) Congress must act to avoid the usurpation of Congressional prerogatives in setting national banking policy by banking regulators and loophole chasers; and 3) Members must not simply avoid the issue and let the market control. The market is not concerned about safety and soundness, or consumers, or credit leverage, or concentration of economic power. Neither, apparently, are the banking regulators who have in the past few years tortured the construction of Congressional intent to authorize banks to engage in a wide range of new activities.

We believe it is imperative that Congress act now to reclaim its role as the arbiter of national banking policy and rein in what have been aptly described as banking's "non-regulator" regulators.

No sooner was the ink dry on the CEBA moratorium than the Federal Reserve authorized a bank holding company to conduct an insurance business directly within the holding company's state bank subsidiary, thus conclusively recognizing the existence of the so-called "South Dakota" or "state bank" loophole and violating the express terms of the moratorium. A federal court has since stayed the Fed's order pending a final decision on the question of whether the Fed has jurisdiction over the nonbank activities of a bank holding company subsidiary bank under the Bank Holding Company Act (BHCA).

We want to take this opportunity to thank the Chairman and the other Members of the Committee who joined in submitting an amicus brief on Congressional intent with respect to the moratorium. The Court clearly found the Congressional brief persuasive in granting the stay.

The action of the Federal Reserve plainly illustrates the disregard by the banking regulators of Congressional intent and the necessity for permanent legislation to conclusively close the state bank loophole. If this loophole is not closed it will permit a single state to affirmatively repeal existing or future BHCA restrictions or prudent restraints on nonbanking activities by bank holding companies.

S. 706, introduced by Senators Heinz and Dodd represents a thoughtful approach to closing the state bank loophole. In so doing it does not infringe on the right of any state to authorize freestanding state banks to engage in insurance activities. It simply limits banks that are part of a holding company system to those insurance activities that are permissible under Section 4 (c) (8) of the Bank Holding Company Act. In addition S. 706 would clarify the authority of national banks and bank holding companies to sell insurance in towns with populations of under 5000.

While S. 706 does not address all of the concerns of insurers about the use of loopholes by banks to enter the insurance business, it represents a useful starting point for discussion. Other issues of concern include the transferability of grandfather rights under exemption D of Section 4 (c) (8) and the definition of the term "incidental to banking" in Section 92 of the National Bank Act.

In this context it deserves mention that the primary legislative proposal under consideration today, S. 1886, is not intended to address the issue of bank entry into insurance or real estate. If S. 1886 were the only legislation enacted before the expiration of the CEBA moratorium on March 1, 1988, therefore, it would once again be open season on insurance and real estate at the whim of the federal banking regulators. This is not what was contemplated when the moratorium was put into effect. The moratorium was devised to give Congress time to address all of the deregulation issues, not just those involving securities.

We would prefer to see Congress adopt S. 706 or similar legislation. However, to the extent that the issues surrounding insurance powers are not addressed, the moratorium must be extended if for no other reason than to preserve Congressional prerogatives.

Conclusion

The life insurance industry believes that the separation between banking and commerce should be retained. For that reason we must oppose S. 1886, S. 1891 and S. 1905. Similarly we urge Congress to act between now and March 1, 1988 to enact legislation along the lines of S. 706 to close the South Dakota loophole and other loopholes through which banks have been attempting to enter the insurance business and circumvent the express intent of Congress. If Congress is unable to agree on any or all of the banking deregulation issues, then the moratorium should be extended with respect to those issues to preserve Congressional options and prevent chaos in the marketplace.

It would be terribly damaging for Congress to permit the moratorium to expire without dealing with the concerns we have expressed. Such action would result in uncontrolled and unstructured deregulation by action of bank regulators and would not serve the best interests of government, business or consumers.

STATEMENT OF THE
NATIONAL ASSOCIATION OF REALTORS®
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
BY
NORMAN D. FLYNN
FIRST VICE PRESIDENT
DECEMBER 9, 1987

INTRODUCTION

Mr. Chairman, my name is Norman D. Flynn. I am a REALTOR® from Madison, Wisconsin, and First Vice President of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 780,000 members of our Association, I want to thank you and the members of this Committee for the opportunity to present our views on the topic of the deregulation of the financial services industry and, specifically, the entry of financial entities into real estate activities such as brokerage, management, investment, and development.

Mr. Chairman, as you and the members of this Committee are aware, the NATIONAL ASSOCIATION OF REALTORS® supported the provisions of the Competitive Equality Banking Act, enacted last August, which established a moratorium on the expansion of financial institutions' powers into real estate activities. The purpose of the moratorium, we continue to believe, is to provide Congress the opportunity to examine, debate, and finally decide the vital issues which comprise this nation's Federal banking policy. In line with this, Mr. Chairman, we hope to communicate the following point clearly to the Committee today:

> We strongly believe that it is the exclusive right and responsibility of the Congress, and not some administrative agency, to decide whether financial institutions should be permitted to engage in real estate activities.

TIMETABLE FOR LEGISLATIVE ACTION

It is appropriate for Congress to, from time to time, review our nation's banking policy and to make any changes deemed necessary and in the public interest. The NATIONAL ASSOCIATION OF REALTORS® commends you, Mr. Chairman, for assuming the leadership in this very necessary endeavor, and we pledge to you, and to the members of the Committee, our full participation in the legislative process.

The need for Congress to deliberate and decide this issue is greater now than ever before. On January 7, 1987, the Board of Governors of the Federal Reserve System published a proposed regulation that would, for the first time, allow a bank holding company to become involved in a variety of real estate activities including investment, development, and potentially brokerage and management. The moratorium on expanded powers has temporarily delayed the Federal Reserve Board's attempts to expand bank powers into real estate activities. However, if Congress does not act before the moratorium ends on March 1, 1988, the regulation will be promulgated. Financial institutions will be granted powers beyond those ever contemplated by Congress. In effect, this proposed regulation would allow the Federal Reserve Board to rewrite the fundamentals of our nation's banking laws without Congressional involvement. The NATIONAL ASSOCIATION OF REALTORS® hopes and believes that Congress, not the Federal Reserve Board, will assume full responsibility for any action pertaining to the activities of our nation's financial institutions.

REALTOR® POLICY

The NATIONAL ASSOCIATION OF REALTORS® Statement of Policy for 1988 states the Association's opposition to the involvement of financial entities in real estate:

"We strongly oppose the authority of all financial entities which benefit from federal deposit insurance, favorable tax treatment, and special access to credit (including their parents, subsidiaries, affiliates and divisions) to participate in the business of real estate brokerage, fee appraising, leasing, real estate development, real estate syndication, property management and other real estate services and/or activities not directly related to their primary function. Such activities may conflict with the interests of their customers, threaten the safety and financial stability of the institution, increase the risk of taxpayer liability and pose a threat to the competitive structure of the real estate industry. We are also opposed to the long-term holding of foreclosed property by financial entities."

The NATIONAL ASSOCIATION OF REALTORS®' policy statement reflects our own deliberation of this important national policy question. One of our Association's primary concerns is for the health of the American financial system, upon which both our national economy, and our industry's survival depends. We believe that financial institutions hold an important public trust, and that any legislation or regulation that affects that public trust must not be altered without very careful consideration. In addition, our policy reflects the practical business concerns of our membership - that is the myriad of potential problems that the restructuring of the financial services industry would present to both the American public and to the existing real estate industry.

We believe that after thoroughly examining the issue you will conclude that it is in the nation's best interest to restrict the involvement of financial entities in real estate activities. The NATIONAL ASSOCIATION OF REALTORS® appreciates this opportunity to assist you by raising both the national policy questions and the practical business questions involving financial powers that have been debated among our membership.

THE FINANCIAL MODERNIZATION ACT OF 1987 - S. 1886

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® testified before this Committee last August that our industry relies on the provision of a stable, adequate and affordable supply of mortgage capital, and that a healthy secondary mortgage market is vital to this goal. The NATIONAL ASSOCIATION OF REALTORS® has previously committed to you to support initiatives that will stimulate the continued growth of the mortgage securities market. To this end, the NATIONAL ASSOCIATION OF REALTORS® is supportive of efforts to expand participation in the mortgage-backed securities market by permitting subsidiaries of bank holding companies to underwrite these instruments provided that this new authority is exercised judiciously under the stringent supervision of those regulatory agencies responsible for the safety and soundness of this nation's financial institutions.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® welcomes the Financial Modernization Act of 1987, as introduced by you and Senator Garn, to permit bank holding companies to purchase and own securities firms as subsidiaries, as an appropriate vehicle to authorize financial entities to participate in mortgage-backed securities.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® wishes to distinguish between mortgage-backed securities and all other securities. Mortgage-backed securities have proved, during the late 1970's and early 1980's to be a sound instrument for the issuer. While there is some additional risk associated with these instruments, mortgage-backed securities should provide financial institutions with a higher return at a relatively low cost. Moreover, the benefits to be derived from increased competition far outweighs this risk.

From our perspective, it is important to note that this legislation does not address itself to the separate question of real estate powers for financial institutions. As stated earlier, we believe that this issue must also be addressed before the March 1, 1988 expiration of the moratorium.

THE FINANCIAL SERVICES OVERSIGHT ACT - S. 1891

The legislation introduced by Senators Wirth and Graham, (based on a proposal by E. Gerald Corrigan, President of the Federal Reserve Bank of New York) entitled the Financial Institutions Restructuring Act of 1987, does not appear, from a real estate perspective, to address the question of whether real estate brokerage, management, investment, and/or development should be considered appropriate business activities for financial institutions. Rather, this legislation would establish the "Financial Services Oversight Commission", a Federal inter-agency commission with broad oversight responsibilities for a wide range of financial services firms. The Commission would be empowered to direct the authorization of powers for all financial entities including, in our estimation, the authority for financial institutions to engage in real estate activities. We recommend that the Congress not abdicate its responsibility to decide whether, or how, financial entities should be permitted to engage in real estate activities.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® presently has no position on the concept of "functional regulation" that this legislative proposal advances. While the concept may have merit, we wish to reserve judgment and further comment on this legislation pending review by our membership.

THE DEPOSITORY INSTITUTION AFFILIATION ACT - S. 1905

The legislation introduced by Senators Cranston and D'Amato, entitled the Depository Institution Affiliation Act, would authorize financial institutions, under a new holding company structure, (to be called a "depository institution holding company"), to engage in real estate activities. Mr. Chairman, as stated above, we have no position on the concept of "functional regulation" that this legislative proposal advances.

Therefore, we wish to reserve judgment on this provision of the legislation pending review by our membership. Our understanding is that this legislation would permit a depository institution holding company", or its affiliate, to engage in real estate investment and development activities, but would restrict real estate brokerage activities unless conducted through an existing real estate brokerage company. In other words, the financial institution would not be permitted to create its own real estate brokerage company. We wish to review this legislation more carefully before commenting.

The bill would also establish a "National Financial Services Committee" to coordinate the regulatory oversight over all types of financial institutions. As stated earlier, the NATIONAL ASSOCIATION OF REALTORS® welcomes and encourages the Federal agencies to coordinate their regulation of the financial services industry.

OPPOSITION TO NEW FINANCIAL INSTITUTION POWERS

The NATIONAL ASSOCIATION OF REALTORS® opposes the authorization of expanded real estate powers to financial institutions. We believe that the strength and stability of the American financial system is the backbone of our nation's economic viability. Proposals to restructure our financial institutions must be rigorously examined in order to demonstrate that the changes will enhance the system's viability. Our members strongly support this premise and also believe that financial institution involvement in real estate activities could ultimately jeopardize the financial system. Our primary concerns are:

- o Maintain the Public Trust - We are wary of unnecessarily changing a financial system which has long met its fiduciary responsibility to the public. The Federal charters of these institutions have been written in a manner so as to promote public confidence in this system. There is a grave risk that changes in the permitted activities of these financial institutions would harm their traditional deposit-taking and credit-granting functions and disrupt the payment system on which our economy relies.

- Safety and Soundness of Financial Institutions - We are concerned that a precipitous restructuring of the financial services industry will materially harm the safety and soundness of the financial system. In particular, we are concerned that individual institutions would be allowed to incur unnecessary risk, and that the failure or losses of these institutions would undermine the viability of the entire financial system. The availability and accessibility of mortgage funds is dependent upon a strong, vibrant financial structure and should not be jeopardized by ill-considered deregulation. We strongly question whether real estate activities are appropriate business activities for financial institutions.

- Unfair Competition - The real estate industry is concerned as to how authorizing banks to engage in real estate activities will affect the practical business operations of the existing real estate industry.

The following details the Association's perspective on each of these concerns.

A. Public Trust

Our financial institutions are an essential part of a strong and healthy economic system. For this reason, our national banking policy has long advocated the separation of banking activities from commercial endeavors. The reasons that Congress has espoused this policy include the following:

- The concentration of economic resources in the hands of a very few could adversely affect competition within the financial services industry and in other industries, and as a result, harm the consumer;

- Commercial endeavors might taint the ability of institutions to make impartial decisions on whether to extend or deny credit;

- The public believes that financial institutions will be able to meet deposit obligations under all conditions. Real estate may not be an appropriate business activity for financial institutions because excessive risk exposure might endanger that institution's solvency.

The NATIONAL ASSOCIATION OF REALTORS® believes that a stable financial system, and confidence in that system, is essential to the economic well being of our nation. The public wants and deserves assurance that the financial services industry will be able to provide an efficient means of making payments, available on demand, as well as provide adequate credit to businesses and the general public. It is because of that national goal that financial institutions have been granted special advantages, such as deposit insurance protection and access to credit. These unique benefits constitute a public subsidy that allows these institutions to carry out their special role in our economy.

In today's economy, financial institutions still play a role which is absolutely unique and unlike that of any private corporation. To meet these challenges, the financial institutions must be assured certain protections and advantages provided by the Federal government. However, as long as financial institutions continue to receive these benefits, it is essential that limitations be placed on their permitted non-banking activities.

B. Safety and Soundness of Financial Institutions

The Types of Risk that Affect Financial Institutions:

At a time when recent experience has heightened depositor sensitivity and the danger of illiquidity for financial institutions, Congress should reaffirm its commitment to the objectives of a safe and sound banking system: reduce the potential for conflicts of interest; prevent concentration of economic power in the hands of a few; and avoid the extension of credit being tied to acceptance of other services. It is the view of the NATIONAL ASSOCIATION OF REALTORS® that these broad public policy goals remain valid today.

As commercial banks and thrift institutions offering traditional services come under competitive pressure from security firms, retailers, and nonbank institutions offering these same services, they continue to seek a range of new asset powers, including insurance, direct real estate investment, securities, and interstate banking, from federal and state regulators. The exercise of these new powers has the potential to increase the financial risk to individual depository institutions, and this risk is passed on to and borne by the Federal government through the deposit insurance funds.

For example, in the field of real estate development a financial institution plays a conservative role. It is the responsibility of the financial institution to restrict its participation from all but the most secure projects. A proposal to permit financial institutions to more actively pursue real estate development is an invitation for the institution to undertake a greater degree of risk, and this risk ultimately belongs to the Federal government. Similarly, a financial institution assuming an equity position in real estate development, due to its lack of experience, would be forced to rely on the expertise of the other parties involved in the deal whose sole interest in profit may be in direct opposition to the need for the financial institution to insulate itself from excessive risk.

In practice, individual institutions are exposed to the risks of fraud, adverse interest rate movements, and poor management. It is this sensitivity to risk that concerns our Association and prompts us to urge the Congress to proceed cautiously in the further deregulation of these entities.

Fraud Risk. The most publicized type of risk to financial institutions is fraud. Fraud is responsible for the most costly losses to depositors and insurance agencies. In other types of failures, assets usually retain substantial liquidation value. Fraud, however usually results in the total dissipation of assets. Because of the negative effects of the dissipation of assets on depositors and the system as a whole; it is imperative that financial institutions be restricted from engaging in activities that contain a higher element of risk. Real estate investment is inherently speculative and the potential for great profit is offset by an equally significant potential for loss.

Consider the closing of Vernon Savings and Loan Association of Dallas. Vernon apparently ranked as the most active seller of widely speculative Texas real estate loans during the state's real estate boom of 1982 to 1985. More than 70 institutions nationwide bought at least $450 million in loan participations from Vernon and now face extensive capital loss because of fraudulent management practices. Vernon's former owner has been accused by the Federal Home Loan Bank Board of "looting" the institution of $350 million dollars.[1]

Interest Rate Risk - When interest rates change unexpectedly, the present value of fixed coupon assets and liabilities changes. The greater the difference between the maturity of assets and liabilities, the greater the effect that a change in interest rates will have on a financial institution's capital. Interest rate changes experienced since the late 1970s have shown that the effect of interest rate risk can be very great. In general, unbalanced portfolios expose institutions to excess risks. While large potential rewards come from guessing right about the direction of rates, wrong guesses can lead to large losses.

The experience of Financial Corporation of America (FCA) during the early 1980's is one example of what can befall a financial institution which guesses wrong on the direction of interest rates. The FCA originated a large volume of fixed-rate mortgages with the expectation of a decline in rates. This created an assets and liabilities maturities mismatch and was a major factor in the failure of FCA when rates did not decline.

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[1] American Banker, November 23, 1987. Pg. 6. November 30, 1987. Pg. 5.

Another major problem, surfacing later, was asset quality. Mortgage loans originated by FCA were found to have been very poorly underwritten which contributed heavily to the institution's failure. To reiterate what we have stated previously, the fact that financial institutions are inherently subject to several kinds of risk must be factored into any decision to expand the scope of their authority.

Managerial Risk - The proposed legislation provides for financial institutions to use affiliated organizations or subsidiaries to spin-off those activities of a non-traditional nature. This involves the possibility that a financial institution will be operated when its costs exceeds its revenues, thus depleting its equity capital. Further, real estate activities are management intensive, requiring specialized expertise. Financial institutions have not historically possessed this type of in-house expertise. We doubt whether an affiliate could be staffed by the financial institution any better. In fact, we would caution that ambitious managers might over-extend their firms without the benefit of specialized knowledge of a newly authorized business, with the result being an undermining of the financial system.

The financial industry's experience with real estate investment trusts (REITS) is an example of potential managerial risks involved in real estate activities. Chase Manhattan Bank, for example, suffered a multimillion dollar exposure when its REIT affiliate, Chase Manhattan Mortgage and Realty Trust, was in financial difficulty due to the downturn in the real estate market. Specifically, the bank purchased loans totalling $160 million from its affiliate and made an additional $150 million in direct loans to its affiliate (the maximum permitted by law) at a time when such affiliate was financially troubled. Similarly, the First Wisconsin National Bank and its parent, First Wisconsin Corporation bailed out its REIT affiliate, First Wisconsin Mortgage Trust, through the purchase of questionable loans. The transactions involved a $10 million exposure in the form of purchase of loans involving a $4.5 million loss in principal and a guarantee against future losses of principal on the REITS remaining loans of up to $5.5 million.[2]

Another example of managerial risk is the case of Continental Illinois National Bank and Trust Company of Chicago when its option subsidiary, First Options of Chicago Inc., required a substantial infusion of funds from the parent. Continental Illinois had been funneling funds into First Options long before the October 29th headlines and was so heavily vested in the subsidiary that it couldn't let it fail.

The critical issue raised by this event is whether Continental Illinois should be engaging in options given the risks involved in these forms of investment and a financial institution's lack of experience in this field. Clearly, this experience also demonstrates that the subsidiary structure does not necessarily guarantee insulation of risk from the parent or its subsidiary financial institution. As a result of Continental's mishandling of its funding of First Options, the House Energy and Commerce Subcommittee on Telecommunications and Finance has scheduled an investigation into improper loans made by Continental to First Options. We applaud Chairman Markey's decision to quickly investigate potential abuses of this new authority and urge this house to proceed cautiously in further deregulating the financial services industry.

The current laws that keep depository institutions out of areas not closely related to banking were enacted because when a depository institution makes a bad decision, the public and the economy suffer the consequences. We believe that the measure of whether the current financial system is working is not the number of financial institutions that exist, nor their profitability; for Congress, we believe that this measure should be the degree of the system's

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[2] DiLorenzo, Vincent. Public Confidence and the Banking System: The Policy Basis for Continued Separation of Commercial and Investment. The American University Law Review. Volume 35, Spring 1986, Number 3. The Washington College of Law, The American University.

safety and soundness. Further, in response to those who reason that expanded powers are necessary to promote the safety and soundness of financial institutions, we would remind them that these powers involve significant risk along with the potential for greater profit. Thus, during recessionary or high interest periods the return on these investments may not assist in stabilizing a financial institution's earnings or help them maintain their market share.

Lastly, it is important to note the cyclical nature of the real estate industry and its affect on the profitability of real estate firms. The real estate industry is a cyclical business that prospers during "boom" periods of low interest rates and economic growth, and sufferer during "bust" periods of volatile interest rates, high inflation, and economic recession. The potential for profit is matched by the potential for failure—a reality to which many REALTORS® can attest as a result of the downturn in the economy during the early 1980's. The point is that REALTORS®, as well as other participants in the real estate industry, must manage the risks inherent in our business without the benefit of a government safety net. If we fail, we fail. However, if a financial institution fails, the Federal insurance funds provide relief. Financial institutions are rarely independent, but operate as a component of the financial system as a whole and should be restricted from engaging in higher risk activities in the interest of the safety and soundness of that system.

In sum, the financial system represented by federally-insured financial institutions is inherently fragile. Therefore, deregulatory initiatives providing expanded powers for financial institutions should not be advanced until there is consensus as to how to regulate the industry to ensure both safety and soundness and optimal delivery of financial services.

C. Competition

Mr. Chairman, as you know, REALTORS® are not afraid of competition. Our industry, because of its relative ease of entry, is one of the most competitive businesses in America. Nevertheless, the members of the NATIONAL ASSOCIATION OF REALTORS® are grievously concerned about the unfair competitive advantages financial institutions could possess if allowed into our line of business.

The real estate industry consists of small, independent businesspeople, who, by their own determination and energy earn a living by performing certain real estate services. The bulk of our members work on a straight commission basis with no guaranty of any minimum income. To the extent that a new person, or company, enters into our industry, the competition that evolves takes place between equals. The business of real estate brokerage is one of customer service and the result of competition within our industry is better service to the homebuying public. This is competition among equals. Our concern is that financial institutions, or their potential real estate affiliates, would not compete as equals in the real estate brokerage, management, or development industries.

The following details some of the specific advantages that a financial institution would have over the existing real estate industry. These competitive advantages would be of concern depending on whether the authorized real estate activities were performed directly through a department of a financial institution, its holding company, or its subsidiary.

Allocation of Resources - Financial institutions enjoy tax benefits that would allow them to utilize a greater proportion of their resources toward competition than existing real estate companies are able. Additionally, a financial institution's real estate firm would gain a competitive advantage from the use of its parent's resources, such as clerical staff, building, files, and equipment.

Federal Deposit Insurance - The existing Federal deposit insurance system fosters speculation in nonbanking activities by financial institutions. For example, no adjustment in insurance premiums is made for those financial institutions which choose to engage in high risk non-banking activities. Therefore, the deposit insurance system actually provides a "cushion" of safety for those financial institutions engaging in these activities, without requiring those institutions to pay accordingly. In effect, the insurance system subsidizes these institutions, giving them a significant competitive advantage in the marketplace and, at the same time, subjecting the Federal deposit insurance funds to additional risk.

Access to Special Credit - Federally chartered commercial banks may obtain below-market funds from the Federal Reserve Discount Window and the Federal Funds Market. Federally chartered savings and loans have the ability to obtain loans in the form of Federal Home Loan Bank Board advances. In both cases, the access to below market credit represents a significant advantage over other business entities.

Economic Discrimination - Financial institution-owned real estate firms would competitively benefit from a parent federally-insured financial institution's ability to provide discounted interest rates, fees, and/or quickened loan approval processes to its real estate subsidiary's clients.

Affiliations and Tie-Ins - Financial institution-owned real estate brokerage or management firms would competitively benefit from the use of their parent federally-insured financial institutions' name, trademark, or logo. The brokerage or management firm would also competitively benefit from any indication, either expressly stated or implied, of affiliation to the financial institution in public advertising by the subsidiary.

Geographic Location - Financial institution-owned brokerage or management firms would competitively benefit from their location in or near the facility of the federally-insured financial institution.

Joint Marketing - Financial institution-owned brokerage or management firms would competitively benefit from joint marketing arrangements with their parent financial institution.

Consumer Access - Financial institution-owned real estate firms would competitively benefit from access to confidential credit information, available from the parent federally-insured financial institution, used for solicitation purposes. Additionally, financial institutions already enjoy a special relationship with consumers which would provide a distinct advantage if permitted to be used in another market.

Management - Financial institutions would competitively benefit from sharing management and staff with their federally-insured financial institutions. This would afford a real estate subsidiary a valuable access to the leadership of the financial institution and an ability to develop economies of scale.

To illustrate the nature of such unfair competitive advantages, the IOWA ASSOCIATION OF REALTORS® has reported the following actual events. It should be noted that Iowa's state institutions have been permitted to broker real estate for several years.

A broker in a western Iowa metropolitan board made several visits to southwest Iowa to assist one of his salespeople in listing a property. The client wanted to list but informed the salesperson that a banker in the community was also licensed, and the banker had informed the prospective client that financing would not be available if the property was listed with someone other than the banker.

A salesperson with a firm in a western Iowa metropolitan board took a client into a Savings and Loan for a loan application. A vice president of the S&L called the buyer later in the day and said that before they could proceed on that particular house, that the S&L's trust department had some properties to show them.

A Waterloo REALTOR® had a house listed for several months. The sellers were several months behind in payments and could not come up with the money. While the listing was still in effect, the S&L who held the mortgage called on the sellers and said they were going to foreclose. However, they said that they would give them an additional three months if they would list the property for sale with them. The listing firm, not wanting to place the sellers in jeopardy, released them from the listing.

CONCLUSION

Mr. Chairman, in 1982, the Congress passed legislation granting depository institutions limited expanded powers designed to promote efficient diversification of portfolio assets. It is still unclear whether even this expansion of authority has been successful. Many institutions have rushed to take advantage of previously restricted activities like brokered deposits, commodity trading, and commercial real estate equity financing. Many did so before examining the full extent of the risks involved in these areas. There is often a direct link between investment in these activities and failed institutions. Moreover, the existing regulatory structure has failed to keep up with events in the marketplace that now threatens to erode the safety and soundness of the entire financial system.

Mr. Chairman, this is the time to ensure the safety and soundness of the banking system. Thus, we would urge Congress not to make decisions based solely on events occurring in the market, but rather, examine, with scrutiny, the level of the system's safety and soundness, as measured by whether our capital markets are orderly and, above all else, how the public trust in that system is protected. We should not permit innovations in the marketplace to jeopardize the ability of our depository institutions to serve the long-term credit needs of the public.

Thank you, once again, for the opportunity to comment on the expansion of bank powers into real estate activities. The NATIONAL ASSOCIATION OF REALTORS® looks forward to working with you as you endeavor to examine this critical issue and formulate policy.

I will be happy to answer any questions.

The **Chairman**. Thank you very much, Mr. Flynn.

Mr. Olson.

STATEMENT OF THOMAS N. OLSON, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION; PRESIDENT, LISCO STATE BANK, LISCO, NE

Mr. **Olson**. Thank you very much, Mr. Chairman.

My name is Tom Olson. I am president of the Independent Bankers Association of America and I'm also a community banker from rural America, Lisco, NE, all my life. So I represent not only the association today but certainly community banks.

First, Mr. Chairman, I would like to take this opportunity to thank you and other members of this committee for the fine work that you did on H.R. 27, the Competitive Equality Banking Act. That bill recapitalized FSLIC. It assisted our troubled farm banks and it permanently closed the nonbank bank loophole.

As you know, the nonbank bank issue went to the heart of our economic and financial system and Congress rightfully, in our opinion, decided to maintain the separation of banking and commerce.

We would also like to commend Senator Garn for working so diligently during the early 1980's to secure new products and services for banks. We also applaud again Chairman Proxmire for attempting to move legislation providing new powers for banks in the context of S. 790 earlier this year. We supported the elements of S. 790 then and we support them now.

The legislative proposals now before this committee, however, are, unfortunately, far more radical. IBAA recognizes that important changes are taking place in the financial marketplace and while we can endorse certain changes, safety and soundness remain our primary consideration.

In the areas of new products and services, our members are interested in having additional powers in the insurance, real estate, and the securities areas which are closely related to banking. Most of the new services our member banks are interested in do not involve significant risks to our banks.

However, our interest in new powers is tempered by concern that legislation could involve unfavorable tradeoffs adversely affecting deposit insurance, the dual banking system, the restrictions on the grandfathered nonbank banks, and financial concentration.

IBAA'S POSITION ON KEY ISSUES

Let me just briefly summarize IBAA's position on key issues. First, we urge the Congress to keep its promise not to extend the moratorium.

We support new means by which community banks can offer competitive products and services that are closely related to banking. We support a step-by-step approach to granting banks additional securities powers rather than the repeal of the key sections of the Glass-Steagall Act.

We will vigorously oppose any legislation that weakens the nonbank restrictions of CEBA or that compromises deposit insurance coverage or the McFadden Act.

Some of the member banks of our association recommend that Congress permit smaller banks with out holding companies to exercise at least some powers within the bank or a subsidiary of the bank within the restraints again of safety and soundness.

While the moratorium on regulatory expansion of banking powers was aimed specifically at the actions of federal agencies, it also prevents State-chartered banks from taking advantage of State-authorized powers. The possibility of experimentation at the state level inherent in the dual banking system provides important opportunities for States to develop products that best serve their consumers and businesses. The moratorium imposes a total roadblock to further experimentation which should be removed.

The IBAA supports new securities powers which are meaningful for community banks. We have serious concerns about the impact of the repeal of both section 20 and 32 of Glass-Steagall, and what impact it would have on small banks and our entire financial system.

The events of Black Monday should make this committee very sensitive to the fragile nature of the financial markets and the importance of the Federal Government's safety net. The separation of commerce from banking and commercial banking from investment banking has existed in the United States for many years. The chief rationale for this long-standing policy has been to prevent the conflicts of interest which could, if allowed, undermine the integrity, the safety, and the efficiency of our Nation's financial system. IBAA believes that these laws are prudent and that they do work.

The arguments being made by those who favor breaking down of these legal barriers is that adequate firewalls can be built between banks and the special banking safety net and the activities of more risky subsidiaries and, thus, if the subsidiaries get in trouble, the bank and the Federal Government's safety net can be insulated.

If the firewalls don't work, if a bank holding company really cannot be effectively insulated from its subsidiary, the legislation pending before this committee is contrary to the safety and soundness of our financial system and has the potential of vastly increasing the scope of the Government's safety net.

Is this the step that should be taken and do the benefits outweigh the risks? Well, we are afraid that they do not. Therefore, IBAA supports a step-by-step approach to deregulation. As a first step in the securities area, we support proposals that would give banks additional powers such as mutual funds, brokerage with advice, and municipal revenue bonds.

This step-by-step approach permits additional competition in the securities business and the banking business without a wholesale restructuring which requires almost impenetrable firewalls. It also gives Congress the opportunity to evaluate the results over a period of time.

We are concerned about the potential concentration of power and wealth that could result from the repeal of Glass-Steagall. We do not see how competition in either the banking or the securities industry is enhanced when existing companies simply buy each other. No new competitors are added to either industry. Instead, the corporate deck is reshuffled and ever-larger institutions are created.

Under our step-by-step approach, major banks would be discouraged from buying major securities firms or vice versa. Rather, banks would enter the securities business on their own and develop competitive alternatives in the marketplace. There would be no need for specific concentration limits and no manipulation of balance sheets to avoid those limits.

Finally, by federalizing the area of securities powers and foreclosing any State action in this area, S. 1886 has serious implications for our dual banking system. It would turn the temporary moratorium in H.R. 27 into a permanent mandate that all banks, both State and national, conduct securities activities through the Federal structure set out in the bill.

It cuts State legislatures completely out of the area of securities powers for their charter banks. Of course, this trampling on States' rights affects only the banking industry since the thrift industry is not covered by S. 1886. State-chartered thrifts may continue to look to their State legislatures for securities powers.

A recent FDIC survey indicated that well over half the States have approved some types of securities powers for their banks, ranging from discount brokerage to underwriting municipal revenue bonds. We are not aware of any serious problems resulting from securities powers granted to State banks by their legislatures. Therefore, the infringement of States' rights in S. 1886 is unnecessary and undesirable.

Mr. Chairman, your bill does not address the issues of new real estate and insurance powers for banks. Frankly, for smaller banks, new powers in these areas are more attractive than securities powers. In light of this, IBAA must remain very sensitive to the adverse tradeoffs which would make the situation of our member banks more difficult.

In this connection, it should come as no surprise to the members of this committee that IBAA will oppose with all its resources any weakening of the restrictions on the grandfathered nonbank banks. We were very pleased that the loophole was permanently closed. We remain disappointed that so many nonbank banks were grandfathered.

We also hope the Congress will resist the temptation to make significant adverse changes in deposit insurance. For our members, deposit insurance is still the most important aspect of their operations. If commercial banking and investment banking are commingled, down the road new questions will be raised about the safety net of which deposit insurance is an integral part.

State control over geographic expansion of banking is also an important concern. Though many States have adopted laws permitting regional and national banking ownership in recent years, they are quite varied and several States have not adopted any form of interstate banking. The diversity in present arrangements suggests that there is no one scheme that is best for every State.

Finally, we are concerned about potential tradeoffs in the areas of insurance and real estate powers. As indicated earlier, these areas are of much greater interest to community banks than securities powers. We cannot support legislation which linked new securities powers with an extension of the moratorium on real estate and insurance powers.

S. 1886 does contain several positive provisions for community banks—municipal bonds and mutual fund powers, the $500 million exemption from the interlock restrictions, and the expedited procedures for forming a bank holding company.

Mr. Chairman, when you introduced S. 1886, you cited a number of potential benefits——

The CHAIRMAN. Mr. Olson, could you wind up in about a minute or so?

Mr. OLSON. We do feel that these are significant benefits and we do not believe that the only way to provide such benefits is through the repeal of the Glass-Steagall Act.

Let me just briefly mention again with reference to S. 1891, I'd be glad to respond to that. We have concerns about it, but we think it has some positive things for the banking industry.

I'd be glad to respond to questions. Thank you.

[The complete prepared statement of Thomas H. Olson follows:]

TESTIMONY

of

THOMAS H. OLSON

PRESIDENT
of the
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

and

PRESIDENT, LISCO STATE BANK, LISCO, NEBRASKA

on

THE FINANCIAL MODERNIZATION ACT OF 1987
and the
FINANCIAL SERVICES OVERSIGHT ACT

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

WEDNESDAY, DECEMBER 9, 1987
ROOM 538 DIRKSEN SENATE OFFICE BUILDING
WASHINGTON, D.C.

Introduction

Good morning, Mr. Chairman. My name is Tom Olson and I am the President of the Independent Bankers Association of America and the president of Lisco State Bank in Lisco, Nebraska. The Independent Bankers Association is the only national trade association that exclusively represents the interests of independent community banks.

First, Mr. Chairman, I would like to take this opportunity to thank you and the Members of this Committee for your fine work on H.R. 27 (the Competitive Equality Banking Act), the bill that recapitalized FSLIC and permanently closed the nonbank bank loophole. As you know, the nonbank bank issue went to the heart of our economic and financial system and the Congress rightfully, in our opinion, decided to maintain the separation of banking and commerce.

We further commend Senator Garn for working so diligently during the early 1980s to secure new products and services for banks. As you know, this did result in the overwhelming passage by the Senate in 1984 of legislation providing such new products and services. Unfortunately, the House Banking Committee was not willing to move this bill. We also applaud Chairman Proxmire for attempting to move legislation providing new powers for banks in the context of S. 790 earlier this year. We supported these elements of S. 790 then and support them now. The legislative proposals now before this Committee are unfortunately far more radical.

The IBAA recognizes that important changes are taking place in the nation's financial marketplace. Banks face increasing competition from non-bank financial companies with bank-like products, that also have the ability to offer federally-insured deposit products. In addition, the assets of many banks, both large and small, have declined in quality. These changes, along with aggressive bidding for deposit funds, volatile debt and equity markets, and narrowing interest margins have resulted in a continuing focus on the regulation and structure of the financial services industry. We continue to support changes in our financial system. This support for change is also dictated by the pressure on earnings experienced by community banks.

While the IBAA can endorse certain changes, safety and soundness remain our primary considerations. They have to, since many of our member banks, which are not too big to fail, are facing difficult times. Consumers now share this concern, as illustrated by the flight of funds into insured deposit instruments since Black Monday.

Also of primary importance to the IBAA is the necessity to terminate as scheduled the new powers moratorium imposed on banks through H.R. 27 and the maintenance without compromise of the restrictions that Title I of that Act imposed on nonbank banks.

In the area of new products and services, our members are interested in having additional powers in the insurance, real estate and securities areas which are closely related to banking. Some of these powers are now available to many banks. Most of the new services our members are interested in do not involve any significant risk to our banks. Our interest in new powers is tempered by concern that legislation could involve unfavorable trade-offs adversely affecting the dual banking system, restrictions on grandfathered nonbank banks and financial concentration. In the long term, co-mingling of commercial banking and investment banking would extend the government's safety net and could adversely affect deposit insurance coverage. This again is of lesser concern to money center banks since they have something better than deposit insurance; they have the ultimate safety net--they are too big to fail.

Summary of Position

Let me briefly summarize the IBAA's position on the issues that have come to the forefront since the passage of the Competitive Equality Banking Act (CEBA):

- We urge the Congress to keep its promise not to extend the moratorium.

- We support new means by which community banks can offer competitive products and services that are closely related to banking.

- We support a step-by-step approach to granting banks additional securities powers, rather than repeal of key sections of the Glass-Steagall Act.

- We will vigorously oppose any legislation that weakens the nonbank bank restrictions in CEBA or that compromises deposit insurance coverage or the McFadden Act.

- Some of the member banks of our association recommend that Congress permit smaller banks without holding companies to exercise at least some new powers within the bank or a subsidiary of the bank, within the constraints of safety and soundness.

The Moratorium

While the moratorium on regulatory expansion of banking powers was aimed specifically at the actions of Federal agencies, it also prevents state-chartered banks from taking advantage of state-authorized powers. Since state-chartered banks would need Federal approval to engage in new activities, a continued moratorium forecloses state experimentation in this area.

The possibility of experimentation at the state level inherent in the dual banking system provides an important opportunity for states to develop products that best serve their consumers and businesses. The moratorium imposes a total roadblock to further experimentation.

Many states have regulatory and supervisory schemes to prevent problems these activities might pose, while others need better funded state banking departments to supervise them. Federal agencies also have tools to prevent state-authorized powers from posing a significant risk to the Federal safety net. Congress and the agencies should rely on these existing safeguards, rather than an indiscriminate moratorium, to protect the safety net from undue risk.

Step-by-Step Deregulation

As I noted earlier, the IBAA supports new securities powers which are meaningful for community banks. Small banks presently are offering discount brokerage services and are brokering mutual funds. We have serious concerns about the impact that repeal of sections 20 and 32 of Glass-Steagall would have on small banks and our entire financial system.

The events of Black Monday should make this Committee very sensitive to the fragility of financial markets and the importance of the Federal government safety net. Former Fed Chairman Paul Volcker's remarks in the November 8, 1987 New York Times must be reflected upon. Volcker ties the bank protections presently in place to the long-evolving stock market crash in 1929 and comments that "it's ironic that all the trumpeting now of these protections stemming from 1929 is being done by the same sources that have been trying to get rid of them and remove all inhibitions on the free markets."

Present law dictates that banks by and large cannot be equity investors or underwriters of securities. This separation of commerce from banking, and commercial banking from investment banking, has existed in the U.S. for many years as a result of the Bank Holding Company Act and the Glass-Steagall Act. The chief rationale for this long-standing policy has been to prevent conflicts of interest which could, if allowed, undermine the integrity, safety and efficiency of our nation's financial system.

The arguments being made by those who favor the breaking down of these legal barriers is that adequate firewalls can be built between banks (and the special banking safety net) and the activities of more risky subsidiaries and thus, if the subsidiaries get into trouble, the bank and the federal government safety net can be insulated. We join Paul Volcker and Gerald Corrigan in questioning this. We recognize that this discussion has almost religious overtones separating those who believe in the efficacy of firewalls and those who don't. If the firewalls don't work--if the bank or the holding company really cannot be effectively insulated from its subsidiary--the legislation pending before this Committee is contrary to the safety and soundness of our financial system and also has the potential of vastly increasing the scope of the government's safety net. Is this a step that should be taken? Do the benefits outweigh the risks?

We are afraid that they do not. Therefore, the IBAA supports a step-by-step approach to deregulation. As a first step in the securities area, we support proposals that would give banks additional powers, such as mutual funds, brokerage with advice and municipal revenue bonds. We believe that this step-by-step approach is in the best public interest. It permits additional competition in the securities business and the banking business without a wholesale restructuring of the financial industry, which requires almost impenetrable firewalls. It also gives Congress the opportunity to evaluate the results over time.

We are concerned about the potential concentration of power and wealth that could result from repeal of Glass-Steagall. We do not see how competition in either the banking or securities industries is enhanced when existing companies simply buy each other. No new competitors are added to either industry. Instead, the corporate deck is reshuffled and ever larger institutions are created. If Congress thinks the securities industry is too concentrated--and that is frequently asserted--it should pass legislation that encourages banks to enter that business without buying major securities firms.

The step-by-step approach which we favor would have just this result. Each step could be small enough to discourage major banks from buying major securities firms--or vice versa--but should be large enough to draw banks into the industry on their own. There would be no need for specific concentration limits and no manipulation of balance sheets to avoid those limits.

Now, some may argue that this approach is unfair, that it is not a two-way street for banks and securities firms. If there is concern about inter-industry fairness, we argue that the step-by-step approach does provide some rough justice. As it stands, securities firms have cut into banks' deposit and lending business by offering such products as cash management accounts, mutual funds and commercial paper. These are not always perfect substitutes for bank products, but then neither would a limited list of securities powers be a perfect substitute for full-scale entry into the securities business.

We are also greatly troubled that S. 1886 does not cover the securities activities of thrift holding companies at all, as earlier drafts of your bill had. This will keep the door wide open for securities firms that want to buy an insured deposit-taking institution, but do not want to comply with the Bank Holding Company Act. Through such activity, the government safety net would be extended to the securities industry. It would also perpetuate regulatory inequities that keep S&Ls under a more lax regulatory structure than banks. Recent financial history makes a persuasive case that this is unwise.

Finally, by "federalizing" the area of securities powers and foreclosing any state action in this area, S. 1886 has serious implications for our dual banking system. As you know, until the passage of H.R. 27, state nonmember banks were not subject to the restrictions of Glass-Steagall. H.R. 27 temporarily extended those restrictions, until March 1, 1988. S. 1886 would turn this temporary moratorium into a permanent mandate that all banks, state and national, conduct securities activities through the federal structure set out in the bill. It cuts state legislatures completely out of the area of securities powers for their state chartered banks.

Of course, this trampling on states rights affects only the banking industry. Since the thrift industry is not covered by S. 1886, state chartered thrifts may continue to look to their state legislatures for securities powers.

The dual banking system performs a valuable function by permitting states to be laboratories for change in banking products and services. A recent FDIC survey indicated that well over half of the states have approved some type of securities powers for their state banks, ranging from discount brokerage to underwriting municipal revenue bonds. We are not aware of any serious problems resulting from securities powers granted to state banks by their legislatures. Therefore, the infringement of states rights in S. 1886 is unnecessary and undesirable.

We are also greatly concerned about the precedent being set by this pre-emption of state authority. In his written statement to your committee, Chairman Greenspan mentioned several times that S. 1886 sets up a framework which could be used as a precedent for the consideration of other products and services at a later time. We would vigorously oppose any attempt to eliminate state authority in other areas, just as we oppose this denial of states rights in the securities area.

Trade-Offs

Mr. Chairman, your bill does not address the issues of new real estate and insurance powers for banks. We are disappointed that the Administration has taken these powers off the legislative table. Frankly, for many smaller banks, new powers in these areas are more attractive than securities powers. In light of this, the IBAA must remain very sensitive to adverse trade-offs which would make the situation of our member banks more difficult.

In this connection, it should come as no surprise to the Members of this Committee that the IBAA will oppose with all its resources any weakening of the restrictions on grandfathered nonbank banks.

Though we were very pleased that the loophole was permanently closed, we remain disappointed that so many nonbank banks were grandfathered.

We also hope that the Congress will resist the temptation to make significant adverse changes in deposit insurance or in the McFadden Act in connection with any bank securities powers bill.

For our members, deposit insurance is still the most important aspect of their operation. If commercial banking and investment banking are co-mingled, down the road new questions will be raised about the safety net of which deposit insurance is an integral part. Deposit insurance is of crucial importance to our banks because the too-big-to-fail government safety net hasn't been extended to them. This problem has been exacerbated by the public's failure to distinguish between banks and thrifts and by well-publicized bank and thrift failures.

State control over geographic expansion of banking is also an important concern. Though many states have adopted laws permitting regional and national bank ownership in recent years, they are quite varied, and several states have not adopted any form of interstate banking. Similarly, some states still have some limits on branching. The diversity in present arrangements suggests that there is no one scheme that is "best" for every state.

That is why we are disturbed by suggestions that any loosening of the Glass-Steagall Act must also be accompanied by a repeal of bank branching restrictions. There has been formal testimony in this regard before the House Energy and Commerce Committee by the Investment Company Institute and Citicorp. The theory is that banks would have some unfair advantage over securities firms in a post-Glass-Steagall environment. This is just another version of the level playing field argument. You can be sure that we will vigorously oppose this type of "tilt adjustment" if it is included in legislation.

Finally, we are concerned about potential trade-offs in the areas of insurance and real estate powers. As indicated earlier, these areas are of much greater interest to community banks than securities powers. We could not support legislation which linked new securities powers with an extension of the moratorium on real estate and insurance powers.

S. 1886 does contain several positive provisions for community banks. Some would take advantage of the new powers to underwrite municipal revenue bonds and distribute mutual funds. The exemption for banks below $500 million from the interlocks restrictions would also be helpful. Finally, the expedited procedures for forming a bank holding company could benefit smaller banks that decide to make such a structural change.

However, any benefits these changes provide are clearly overshadowed and outweighed by the downside of repeal of Glass-Steagall, from our perspective.

Mr. Chairman, when you introduced S. 1886, you cited a number of potential benefits from the bill: increased competition in the highly concentrated investment banking industry; a greater variety of products for consumers at lower cost; and greater risk diversification for banks.

These are all very significant benefits. But we do not believe that the only way to provide such benefits is through the repeal of Glass-Steagall. We contend that our step-by-step approach of providing banks with new securities powers can result in the very same benefits, without the negative implications of repeal that I have described.

We recognize that S. 1886 doesn't give securities firms complete reciprocity. But it does get the camel's nose under the tent in a very significant way. The precedent is set for common ownership of commercial banks and investment banks. Down the road, it is highly likely that a securities firm which acquired one or more banks under the terms of the bill could market its banks' CDs and other depository products in each of their offices across the country. In turn, money center banks would own investment banks and cross market their products under a common logo. In exchange for this new competition from a large, nationwide securities firm, S. 1886 provides new securities powers which are largely irrelevant to many community banks.

Let me turn briefly to the bill introduced by Senators Wirth and Graham, S. 1891. That bill, which attempts to turn the Corrigan paper into legislative language, is a comprehensive effort to look at the long-term needs of our financial system.

The bill contains several very positive features from our perspective. First, rather than simply addressing the area of securities powers, S. 1891 deals with a greater range of products, including insurance and real estate powers. Second, the bill maintains the essential separation of banking and commerce. Finally, it terminates the grandfather status of nonbank banks.

Despite the positive features, we have some serious reservations about the bill. It is one version of the financial services holding company concept, which calls for the common ownership of banks, thrifts, securities firms, insurance companies and real estate firms. We believe that the financial services holding company approach promotes concentration and could lead to the creation of "megabanks." It may also encourage conflicts of interest and tied sales, to the detriment of the consumer.

As drafted, S. 1891 does not specifically address any of these concerns. In addition, we believe that the provisions of the bill delegating to the Financial Services Oversight Commission the authority to determine the types of activities in which banks and other financial companies may engage need further clarification.

Nevertheless, we commend Senators Wirth and Graham for their work on this bill and look forward to working with them in the years ahead. Their bill raises a number of significant structural and regulatory issues which this Committee must address.

Mr. Chairman, it should come as no surprise to the Committee that we strongly oppose S. 1905, the bill introduced last week by Senators D'Amato and Cranston. That bill takes the financial services holding company concept to its worst possible extreme, by permitting any company, from a fast food outlet to a shoe manufacturer, to engage in the banking business.

For over five years, our members, along with small business groups, farm organizations, state officials and consumers, fought the battle to close the nonbank bank loophole. We fought to preserve the essential separation of banking and commerce following the leadership of Fed Chairman Paul Volcker. In passing H.R. 27 and closing the nonbank bank loophole last summer, Congress reaffirmed its support for the principle. It shouldn't be reopened.

Smaller Banks and Powers

As I indicated earlier, a consensus appears to have developed that if banks are to get new powers in this Congress, they must focus on one area at a time. For this round, the consensus has formed in favor of securities powers within the bank holding company format.

That is fine, if you are a major banking institution with a holding company that can capitalize a separate securities subsidiary of the holding company, and a strong desire to enter the wholesale securities business. This proposal is viewed by some of our members as unnecessarily complicating the life of smaller banks not organized into a bank holding company structure.

We recommend for Congressional consideration that, particularly for retail services such as mutual fund sales and securities brokerage, banks be permitted to offer those types of services within the bank. Smaller banks without holding companies, say with assets of $500 million or less, should be able to offer other services in a subsidiary of the bank, provided there are appropriate regulatory safeguards.

Our second point concerns the limited scope of proposed legislation. During our most recent federal legislation committee meeting, we asked each of the bankers there what new powers, if any, they would like to have. Securities was the most controversial, with some wishing to sell mutual funds, offer securities brokerage with advice, and underwrite municipal revenue bonds, while others strongly argued that bankers should not confuse their customers by offering non-insured investments which put those customers' principal at risk.

On the other hand, there was much greater interest among the bankers in having the opportunity to offer insurance and real estate products. As noted, Treasury Undersecretary George Gould, among others, has taken consideration of those powers off the legislative table.

In this connection, I would like to point out that the exemption in the Bank Holding Company Act that permits small--under $50 million--holding companies to offer insurance services has been seriously eroded by inflation and growth in the banking industry. That provision was first proposed in 1979 and adopted in 1982; to cover an equivalent number of banks today the exemption would have to be increased to $100 or $125 million. We hope that even if Congress does not decide to pass major changes permitting banks to underwrite insurance products, the small-bank exemption can be adjusted upward.

Other Issues

Mr. Chairman, I'd like to briefly discuss several other issues which are not directly before your Committee, but are nevertheless very important to community banks.

National Bank Branching

The first is the effort of the Comptroller of the Currency to create a new loophole and overturn individual state laws on branch banking. The problem began in Mississippi, where the Comptroller authorized a national bank to open a branch in an area more than 100 miles from the main bank, in clear violation of state branching laws. Mississippi permits state thrifts to branch statewide, but commercial banks are restricted to within 100 miles of their headquarters.

The Comptroller concluded that Mississippi thrifts are the functional equivalent of banks. Since thrifts can branch statewide, so can national banks, according to the OCC.

This convoluted logic was upheld by the 5th Circuit Court of Appeals and the Supreme Court recently refused to hear an appeal from the Mississippi banking commissioner. With this victory in hand, the Comptroller is now looking for other states where they can overturn restrictive branching laws with this theory. There are at least twenty other states where thrifts have greater branching authority than state-chartered banks and therefore national banks may avail themselves of the Comptroller's logic in conflict with state law.

This Mississippi case presents very important issues beyond the McFadden branching issue. The underlying issue is one of states rights--whether the OCC has the authority to allow national banks in a state to branch in a way that is inconsistent with what state law has allowed for state-chartered banks. The OCC theory denies states the authority to interpret their own state branching statutes. We feel that the Comptroller is once again exploiting loopholes, looking towards imposing his own particular preferences on the structure of banking in this country.

While we are actively considering lawsuits in several other circuit courts to challenge the OCC effort, a legislative solution would be more efficient. We would be happy to work with the Committee on such a solution.

Bank Directors

Let me turn now to another issue of great interest to community banks--interlocking directors. Competent directors are the foundation of a bank's survival and profitability. Community banks are finding it increasingly difficult to find and retain qualified directors due to the economy and liability issues. This problem is further exacerbated by the Interlocks Act of 1978, which prohibits directors or officers from serving on the board of an unaffiliated bank in the same geographic area. Banks are considered affiliates if the same person or group owns more than 50% of the voting shares of the two institutions.

The Act grandfathered existing interlocks until November 10, 1988. This trigger date and the restrictions in the Act are causing an unintended hardship on community banks at a time when bankers are pooling their resources to meet competition.

We would propose four specific changes in the Interlocks Act. The first involves the definition of affiliate. As indicated, current law defines "control" as 50% common ownership of the two institutions. We would like to see this changed to 25%, to reflect the definition of control which is in the Bank Holding Company Act, the Federal Reserve Act and the Change of Bank Control Act.

The second change would be to delete advisory and honorary directors from coverage under the Act.

The third change would be for a five-year exception from the requirements of the Act for any individual or institution which acquired a closed or failing bank.

The final change would be to replace the geographic restrictions in the Act with a competitive market analysis, similar to that performed in a bank holding company formation.

The regulatory agencies are generally sympathetic to the need for changes in this law. The changes we suggest would remove some of the most onerous restrictions on the ability of community banks to find qualified directors to serve on their boards, without compromising the policy of the Interlocks Act to preserve competition.

Foreign Deposits

Earlier in my testimony I discussed the importance of deposit insurance to community banks in view of the fact that they lack the too-big-to-fail protection enjoyed by money center banks. Let me explain why we think this is unfair, and suggest a step the Committee can take to help remedy that inequity.

All banks pay a premium for FDIC insurance protection based on all their domestic deposits, including those over $100,000. However, the insurance coverage for most banks extends only to domestic depositors up to $100,000. In contrast, all deposits--foreign and domestic--at too-big-to-fail banks are covered, and such banks by their very nature present a greater systemic risk to the FDIC. The money center banks do not want to pay a fair premium assessment for their covered deposits, both foreign and domestic. This means that every bank holding foreign deposits gets a free ride and is subsidized by the rest of the banking system. As the Continental Illinois case made clear, foreign deposits are effectively a liability of the FDIC, and all liabilities should bear an assessment.

Money center banks are also presently the beneficiaries of an enormous U.S. government support system not available to smaller domestic banks. The U.S. government is not playing a major role in helping us renegotiate our troubled agricultural and energy loans. There is no IMF support system helping to ensure that interest payments will be made. Small banks are failing in record numbers and the number of problem banks continues to rise in a disconcerting fashion. The perception of small bank depositors is that their deposits over $100,000 are at risk in smaller banks no matter how well run they are.

Congress could partially address this inequity by simply including all deposits, foreign and domestic, in the deposit insurance base. Too-big-to-fail banks would then pay a fairer share for the FDIC coverage they enjoy. And, this proposal could be made "revenue neutral" by decreasing the overall assessment rate that the FDIC imposes.

Conclusion

Mr. Chairman, if the walls between various segments of the financial system are to come down, the job should be done with deliberation and care, and with a full understanding of the ramifications of what we are doing. That is the approach we recommend today. We recognize the need for changes, but we also recognize that maintaining public confidence in the safety and soundness of our financial system is of paramount importance. The fact that the system survived the unprecedented stock market crash suggests that many of our current arrangements have much to recommend them. On the other hand, banking organizations and their customers will both benefit if banks are permitted to offer some new products and services. So we say yes to deregulation, but on a careful, step-by-step basis.

ADDENDUM
To Testimony of December 9, 1987
of the
Independent Bankers Association of America

Section 404 of the Garn-St Germain Act of 1982 authorized the Comptroller of the Currency to charter bankers' banks that would be owned exclusively by banks and intended to provide a variety of correspondent banking services to those banks. There are currently 13 bankers' banks owned by independent banks. They are located in Wisconsin, Virginia, Texas, Pennsylvania, Oklahoma, Ohio, Missouri, Minnesota, Louisiana, Illinois, Georgia, Florida and Colorado.

These institutions are currently providing valuable services, but are hampered by the fact that the federal law did not recognize the growing importance of holding companies among smaller banks. It is now quite common for a small community bank to be held by a one-bank holding company.

As currently drafted, section 404 permits bankers' banks to provide services to "other depository institutions" (meaning they cannot provide service to other businesses or the general public). However, the law does not permit bankers' banks to provide services to bank holding companies. Since many of the bank owners of bankers' banks are themselves part of holding companies, this presents a substantial difficulty because it often makes better business sense for the bankers' bank to provide services to a holding company.

There were attempts to correct this oversight in the technical corrections legislation which passed the Congress in 1982, but the House deleted this provision on the ground that it was not truly a technical issue. Nevertheless, we hope that in the context of any banking legislation that is considered in this Congress this adjustment can be made.

It would also be helpful to resolve a related ambiguity in the law. Section 404 of the Garn-St Germain Act permits bankers' banks to be part of a holding company structure. However, in that case, the ownership of the bankers' bank would, technically, be by its holding company, not by the banks. This appears to contradict the provision that requires that bankers' banks be owned by banks. A clarification of these provisions will become particularly important if new securities powers are required to be performed within a holding company structure. Similarly, we hope that Congress will also recognize the growing use of holding companies by permitting bankers' banks (or their holding companies) to be owned by bank holding companies.

The **Chairman**. Thank you, Mr. Olson.

Senator **Gramm**. Mr. Chairman, may I be allowed to say a few things about my friend and constituent, Bill Bailey?

The **Chairman**. Of course. Go ahead.

Senator **Gramm**. I'd like to say first that Bill is not only here representing the Independent Insurance Agents of America, but he's probably the premier independent agent in my State. He's well known by people throughout the insurance industry in the business community in our State. He's vice chairman of the board of Baylor University and I think it is not an unfair statement to say that they would have to shut down Baylor University without his leadership, though he would still be lurking around on campus if they did that.

So we are honored today to have you here, Bill, and look forward to hearing your testimony.

Thank you, Mr. Chairman.

The **Chairman**. I can understand now why they entitled that song "Bill Bailey, won't you please come home."

Mr. **Bailey**. My wife sings it regularly. [Laughter.]

STATEMENT OF A. WILLIAM BAILEY, JR., VICE PRESIDENT, INDEPENDENT INSURANCE AGENTS OF AMERICA

Mr. **Bailey**. Thank you, Senator Gramm, for those very kind remarks.

Mr. Chairman, I am vice president of the Independent Insurance Agents of America. I am appearing today on behalf of the Alliance for the Separation of Banking and Insurance. This is a coalition of the five national insurance trade associations that represent virtually every insurance agent in America.

SEPARATION OF BANKING FROM INSURANCE SHOULD BE MAINTAINED

We believe that the Congress should maintain the separation of banking from insurance that has served this Nation so well since the passage of the National Bank Act in 1864.

In August, Congress enacted CEBA, which contained a 1-year insurance moratorium. The purpose of the moratorium was clear—to close the so-called South Dakota loophole until Congress has the opportunity to study and pass upon that issue.

But only a month after passage of CEBA, the Fed intentionally defied congressional will by claiming that the South Dakota loophole does indeed exist. In its *Merchants National* order, the Fed held that the insurance restrictions of section 4(c)(8) of the Bank Holding Company Act do not apply to the direct activities of a State-chartered bank subsidiary of a federally regulated bank holding company. The South Dakota loophole thus strips the Fed of authority to regulate the nonbanking activities of State banking subsidiaries whether they are engaged in insurance, real estate development, or other activities deemed by a State to be permissible for its free-standing State banks.

Our coalition immediately challenged the Fed's decision and sought an emergency stay from the court of appeals. We were joined in our efforts by six members of this committee who filed an amicus brief that explained the true purpose of the moratorium.

We were fortunate enough to have the court stay the Fed's order pending judicial review.

The lesson of this episode is obvious. No matter how clear congressional intent or how express the language of legislation, an administrative agency has the power, at least in the short term, to thwart Congress.

Even more disturbing, the Fed has now shown that it has joined forces with the banking industry to destroy the separation of banking and insurance that the Bank Holding Company Act requires.

Before this autumn, we were skeptical that a Federal banking agency would be willing to act as a vigilant watchdog of congressional intent. We must now view with deep suspicion any legislation that provides federal regulatory agencies with discretion to determine when banks may sell insurance.

The Fed's action is simply the latest in a long line of administrative efforts to contravene congressional will. Our written testimony adequately covers other problems the Fed and the Comptroller have created on exemption D and exemption C of section 4(c)(8) and the National Bank Act. These issues are important not only for their individual impact but also for the collective image they create.

What you see is bank holding companies that are being granted expanded powers to sell insurance in any manner and in any place they wish. What you see is two administrative agencies misusing their powers to push congressional intent out of the picture.

I recognize the purpose of this hearing is to discuss pending legislative proposals, not just to review the sorry record of administrative misconduct. Chairman Proxmire and Senator Garn's legislation raises two particular concerns for us.

First, many life insurance agents sell products that require them to be NASD licensed. These products include variable life, variable annuities and guaranteed interest contracts used to fund corporate qualified pension plans. These have been consistently treated as insurance, underwritten by insurance companies, and sold by insurance agents.

Section 102 of S. 1886 permits the sale and underwriting of securities of any type. This language is broad and could be read to permit bank holding companies to sell and underwrite these traditional insurance products. The bill should be amended in order to exclude from its reach any contract registered as a security that is traditionally sold by an insurance agent.

Second, section 203 of the bill would remove the present provision of section 4(c)(8) that guarantees us notice and an opportunity to comment on applications by bank holding companies to engage in insurance activities. We strongly oppose such a change.

The notice and comment provision has provided us with a chance to present our views to the Fed on the substantial legal issues identified earlier.

Although these changes should be made, we do not mean to suggest that we favor legislation that permits expanding nonbanking powers of any type for bank holding companies. The separation of banking and commerce has served this Nation well.

When reviewing the three main reasons put forward in support of proposals to permit bank holding companies to sell insurance, none of the rationales demonstrates that the public and consumers would be well served by the entry of bank holding companies into the insurance agency business. A view held by the consumer groups, incidentally, that testified before the House Banking Committee last week.

First, it is said that deregulation is needed in order to permit U.S. banks to compete more effectively in the international market. Does anyone actually believe that the power to sell insurance will so increase the assets of U.S. banks as to decisively increase the ability of domestic institutions to compete against Japanese and European banks?

Second, it is said that increased powers are necessary in order to create a level playing field. But insurance agents do not stand on the same economic level as big bank holding companies. Independent insurance agencies are small businesses with a median gross annual commission income of approximately $180,000, with six people as a median who must be paid from that income.

Allowing bank holding companies to sell insurance does not put them on a level playing field with us. Citicorp can buy as many insurance agencies as it wishes, but we've not heard anyone suggest that insurance agencies will be able to snap up bank holding companies.

Let it be clear that we are not opposed to fair competition. But, as Chairman St Germain once said, "There is little question that bank holding companies can and do provide the rawest form of unfair competition for small businessmen."

Third, it is asserted that the public will be better served if bank holding companies can sell insurance. But a close examination of reality demonstrates that the risks to the public far outweigh the possible benefits.

It must be emphasized that the market for the sale of insurance is very competitive. We are not a concentrated industry. There is nothing now that prevents the consumer from obtaining the very best value for their money.

Banks would have a tremendous advantage with the capability to tie the sale of insurance to the cost of banking services in order to hide the true cost of insurance, or they can sell insurance at a fair price but through the use of coercive sales techniques increase their market share in a way that makes a mockery of the free market.

Consider the example of the credit insurance sold by banks and subject to regulation by the Fed and the Comptroller.

In the early 1980's, the Fed reviewed the activities of two Missouri bank holding companies. The penetration rate was staggering. One of the bank holding companies had 38 bank subsidiaries, of which 14 had penetration rates of 80 percent or better. Four of the banks had penetration rates of 100 percent, and the record of the other bank holding company was just as significant.

Was this success based on a better price? Not at all. As one judge wrote, "The evidence revealed the spectacle of an extremely successful sales program peddling overpriced coverage to a captive market."

Because the ability the banks have to coerce their customers, either implicitly or expressly, the risk to consumers is great.

S. 1891 distinguishes between banking services, financial services and commerce. It would invest a newly created commission with the responsibility for determining the type of activities permissible for holding companies. We think the distinction is between banking services and commerce. We don't know what financial services are. We do know that we are not trying to invade the banking business.

S. 1905, sponsored by Senators Cranston and D'Amato, goes even further than S. 1891. S. 1905 would, as Senator D'Amato explained, allow any type of business to engage in insurance, banking, securities and other financial service activities. Insurance agency activities cannot be grouped with financial services.

Insurance agents are not the owners of giant financial service companies. We do not have the capacity to invade the turf of banks. Expansion of banks into our business would not preserve competitive equity and enhance market efficiency, which is a statutory goal set forth in S. 1891.

In sum, we believe that the current system has worked well when Federal regulators have followed congressional intent. A careful review will demonstrate that Congress has kept banks out of the insurance business for good and sound reasons, and that those reasons continue to be valid today.

Thank you, sir.

[The complete prepared statement of A. William Bailey follows:]

Another issue of concern to the bankers' banks is the lending limits on state-chartered Federal Reserve member banks. Presently, state member banks are subject to the lending limit set forth in Section 11(m) of the Federal Reserve Act. This section of the Act limits the amount of a loan secured by stock or bond collateral to ten percent of a bank's unimpaired capital and surplus. Nationally chartered banks are subject to a limitation of 15 percent of capital and surplus as specified in Section 84(a)(1) of Title 12, USC. This limit was set in the 1982 Garn-St Germain Act.

This is discriminatory for state member banks which must adhere to the ten percent limitation. In addition, many states have adopted the 15 percent collateralized lending limitation which is available to non-Fed members. As a result of these differences, the type of charter plays a more important role in determining lending limit restrictions than does safety and soundness.

We believe this difference adversely affects the efforts of state-chartered member banks in making sound, well-collateralized loans. In particular, state member bankers' banks engaged in bank stock lending encounter much difficulty with Section 11(m). Since this law applies only to stock and bond collateralized loans, it encourages banks to engage in less secure lending practices by avoiding stock or bond collateral in favor of unsecured loans in order to minimize the possibility of violating the statute.

The solution to this inequity is to allow state member banks to make secured loans to a single borrower subject to the same limits as are applied to national banks under the Garn-St Germain Act. We hope Congress makes this change in Section 11(m).

Testimony of

A. William Bailey
Vice President of the Independent
Insurance Agents of America, Inc.

Presented before the

Committee on Banking, Housing
and Urban Affairs

United States Senate

December 9, 1987

The testimony is on behalf of the
Alliance for Separation of Banking and
Insurance, consisting of:

Independent Insurance Agents of America
National Association of Life Underwriters
National Association of Professional Insurance Agents
National Association of Casualty and Surety Agents
National Association of Surety Bond Producers

STATEMENT OF THE ALLIANCE FOR THE SEPARATION OF BANKING AND INSURANCE

Mr. Chairman. My name is William Bailey and I am president of Bailey Insurance of Waco, Texas. I am also vice president of the Independent Insurance Agents of America, Inc.

I am appearing today on behalf of the Alliance for the Separation of Banking and Insurance (ASBI): a coalition of the five national trade associations that represent insurance agents and brokers across the nation. ASBI includes the Independent Insurance Agents of America, Inc., The National Association of Casualty & Surety Agents, The National Association of Life Underwriters, The National Association of Professional Insurance Agents and the National Association of Surety Bond Producers. Together we believe that the Congress should maintain the separation of banking from insurance that has served this nation so well since the passage of the National Bank Act in 1864.

We appreciate the opportunity to appear before you today. Our purpose is threefold: first, to bring the Committee up to date on the threatening developments that have taken place since passage of the Competitive Equality Banking Act; second, to explain our concerns at the manner in which federal banking agencies are attempting to rush ahead of congressional action by freeing banks and bank holding companies from legal restraints, and third, to discuss three bills that would expand banking powers, the first offered this fall by Chairman Proxmire and Senator Garn, the second sponsored by Senators Graham and Wirth, and the third sponsored by Senators Cranston and D'Amato.

I. The Fed Attacks The Insurance Moratorium

In August, Congress enacted the Competitive Equality Banking Act of 1987. The Act contains in Title II an insurance moratorium designed to stop federal banking agencies, including the Federal Reserve Board, from issuing any orders that would have the effect of increasing the insurance powers of any bank or bank holding company and from approving any acquisition by a bank holding company that would lead to ownership of a bank engaged in insurance activities labeled impermissible by Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended.

The purpose of the insurance moratorium is clear: to close the so-called "South Dakota" loophole until Congress has the opportunity to study and pass upon that issue.

But only a month after passage of CEBA, the Federal Reserve Board intentionally defied the will of Congress expressed in Title II. On September 10, the Fed issued an order permitting Merchants National Corporation, an Indiana bank holding company, to engage in general insurance activities through two of its state-chartered banks in Indiana.

We immediately challenged the Fed's decision and sought an emergency stay from the United States Court of Appeals for the Second Circuit. We were joined in our efforts by six members of this Committee, Chairman Proxmire and Senators Riegle, Dodd, Heinz, D'Amato and Shelby, who filed an amicus brief that explained the true purpose of the moratorium. On October 6, we were fortunate enough to have the Court stay the Fed's Order. Last week, oral argument on the case was held in New York.

The lesson of this episode is obvious. No matter how clear is the expression of Congressional intent; no matter how express is the language of legislation; an administrative agency has the power -- at least in the short term -- to thwart legislation enacted by Congress. And, even more disturbing, the Fed has now shown that it has joined forces with the banking industry to destroy the separation of banking and insurance that the Bank Holding Company Act requires.

That lesson has implications for the future. Before this fall, we were skeptical that a federal banking agency would be willing to act as a vigilant watchdog of our interests. Now we know that even the Fed is willing to abdicate its responsibility. We must now view with deep suspicion any legislation that provides the Fed or any other federal regulatory agency with discretion to determine when banks and bank holding companies may sell insurance.

II. The Comptroller and The Fed Have Embarked On A Systematic Effort to Increase The Insurance Powers of Banks and Bank Holding Companies Before Congress Acts

Our concern does not arise, of course, merely with the Fed's Merchants National Order. Rather, the Fed's action is simply the latest in a long line of administrative efforts to contravene congressional will. I would like to take a few minutes to briefly identify and explain the issues and the threat they pose to us.

First and foremost is the "South Dakota" loophole. In its Merchants National Order the Fed has held that the insurance restrictions of Section 4(c)(8) do not apply to the direct activities of a state-chartered bank subsidiary of a bank holding company. The "South Dakota" loophole thus allows any bank holding company to avoid the restrictions of Section 4 merely by re-organizing its internal corporate structure. It permits state officials to conspire with bank holding companies to repeal Section 4 on a state-by-state basis. It strips the Fed of the authority to regulate the nonbanking activities of state-bank subsidiaries whether they are engaged in the insurance business, in real estate development, or in any other activity deemed by a state to be permissible for its free-standing state banks.

Of course, the Fed's interpretation of the Bank Holding Company Act is wrong. We are filing today, along with this testimony, a copy of our opening brief filed in the Merchants National case in New York. That brief demonstrates that the Fed's interpretation is contrary to the language, legislative history and fundamental purposes of the Bank Holding Company Act.

Second, the Fed has ruled that the grandfather rights created by Exemption D of Section 4(c)(8) for bank holding companies that were selling insurance prior to May 1, 1982 may be freely transferred to other banking holding companies. This ruling conflicts with the Fed's own precedent, and with the purpose of the grandfather clause: to protect legitimate expectations but not to create special, and valuable, franchises for some bank holding companies. It is ironic that the Fed has taken the opposite -- and correct -- view of another grandfather clause, Exemption G.

Third, the Fed has ignored legislative history by ruling that any bank holding company can invoke the "small town" exception contained in Exemption C to Section 4(c)(8). The Fed has thus disregarded the plain Congressional intent that the "small town" exemption be available only to bank holding companies that have their principal place of banking business in a small town. The effect is to permit the largest bank holding companies to take advantage of an exception that was crafted for the use of only the smallest bank holding companies.

Our difficulties are not confined, of course, to the Fed. The fourth example of administrative misbehavior comes from the Office of the Comptroller. The Comptroller has the initial responsibility for determining what kinds of nonbanking activities are "incidental" to banking under Section 24 of the National Bank Act. In 1968, a federal court of appeals directly ruled that Section 24 does not permit a national bank to engage in broad forms of insurance activity.

But that has not stopped the Comptroller. He has ruled that the sale and underwriting of both municipal bond insurance and title insurance is "incidental" to banking. Both decisions are now before the courts; but the tenor and scope of the Comptroller's view make clear his plan to break down any restrictions on the ability of national banks to engage in insurance sales or underwriting.

Fifth, and finally, Section 92 of the National Bank Act permits national banks located in small towns to sell insurance. That provision was enacted in 1916 in order to provide additional income for small, rural banks in places where insurance alternatives might not be available. But the Comptroller has ruled that any national bank with a branch in a small town may sell insurance to customers located anywhere. The Comptroller's ruling, if not reversed by the courts, would open up general insurance activity to every national bank and bank holding company that can locate a branch in a convenient small town.

Some of these issues are obviously more threatening than others. They are important, however, not only for their individual impact but also for the collective image they create. Its not hard to see what emerges if you connect the dots. What you see is banks and bank holding companies that are being granted expanded powers to sell insurance in any manner and in any place they wish by two administrative agencies misusing their powers to push congressional intent out of the picture.

III. The Proposed Legislation

We recognize that the purpose of this hearing is, of course, to discuss pending legislative proposals, not just to review the sorry record of administrative misconduct.

Chairman Proxmire and Senator Garn have introduced legislation, S.1886, which would permit bank holding companies to engage in securities underwriting in a manner now prevented by the Glass-Steagall Act. Before we note our general view of such legislation, two particular concerns should be identified.

First, and as the Committee may know, many life insurance agents sell products that require them to be licensed by the National Association of Securities Dealers. These products include variable life insurance, variable annuities, and guaranteed interest contracts used to fund corporate qualified pension plans. Although such products technically constitute securities, they have been consistently treated as insurance by insurance regulatory authorities, underwritten by insurance companies and sold by insurance agents.

Section 102 of S.1886 permits the sale and underwriting of securities "of any type." We do not understand the intent of the legislation to infringe in any way on the normal activities of life insurance agents. But the language is broad and could be read to permit bank holding companies to sell and underwrite these traditional insurance products. Accordingly, we urge Chairman Proxmire and Senator Garn to amend S.1886 in order to exclude from its reach any contract registered as a security that is issued by an insurance company or sold by an insurance agent.

Second, it appears to us that Section 203 of the bill would remove the present provision of Section 4(c)(8) that guarantees us notice and the opportunity to comment on applications by bank holding companies to engage in insurance activities. We strongly oppose such a change. The notice-and-comment provision in current law has provided us with the chance to present our views to the Fed on the substantial legal issues identified earlier, including the "South Dakota" loopholes. Indeed, without these procedural protections, we might not even have known of the Merchants National application that led to the current litigation.

Although these changes should be made, we do not mean to suggest that we favor, even in an amended form, any legislation that permits expanded nonbanking powers for bank holding companies. The separation of banking and commerce has served the nation well. The burden of demonstrating the need for change must come, we think, from those who favor departure from the present system. In our view, that burden has not been satisfied.

We look most closely, therefore, at the reasons put forward in support of proposals to permit bank holding companies to sell insurance. We have heard three different reasons to justify this fundamental change in current law. But none of the rationales we have heard thus far demonstrate that the public would be well served by the entry of bank holding companies into the insurance agency business.

First, it is said that deregulation is needed in order to permit U.S. banks to compete more effectively in the international market. The problems of international trade are real. But does anyone actually believe that the power to sell insurance will so increase the assets of U.S. banks as to decisively increase the ability of domestic institutions to compete against Japanese and European banks?

Second, it is said that increased powers are necessary in order to create a level playing field. But insurance agents do not stand on the same economic level as big bank holding companies. A recent survey demonstrates that independent insurance agencies are small -- not large -- businesses. The median independent insurance agency in the United States generates a gross annual commission income of approximately $180,000 and employs six people who must be paid from that income. Additionally, all customary business expenses are incurred. Nearly half of the independent insurance agencies have a gross income of $150,000 or less.

Allowing bank holding companies to sell insurance does not put them on a level-playing field with us. It gives them a huge advantage. Citicorp can buy as many insurance agencies as it wishes. But we've not heard anyone suggest that insurance agencies will be able to snap up bank holding companies.

Let it be clear that we are not opposed, in any fashion, to fair competition. But, as Chairman St Germain of the House Banking Committee once said, "[t]here is little question that bank holding companies can and do provide the rawest form of unfair competition for small businessmen."

Third, it is asserted that the public will be better served if bank holding companies are permitted to sell insurance. But a close examination of reality demonstrates that the risks to the public far outweigh the possible benefits.

Initially, it must be emphasized that the market for the sale of insurance is very competitive. We are not a concentrated industry. There is nothing that now prevents the consumer from obtaining the very best value for his or her money. In this way, the market for the sale of insurance differs markedly from the market for the underwriting of securities, as described by Chairman Proxmire in his statement introducing S.1886.

Banks have a tremendous advantage with their capability to tie the sale of insurance to the cost of banking services in order to hide the true cost of insurance. Or, they can sell insurance at a fair price but, through the use of coercive sale techniques, increase their market share in a way that makes a mockery of the free market.

Consider the example of credit insurance, traditionally sold by national banks and bank holding companies and subject to regulation by the Fed and the Comptroller. In the early nineteen eighties, the Fed reviewed the activities of two Missouri bank holding companies. The administrative record demonstrated that the percentage of bank customers to whom the bank sold insurance, the so-called penetration rate -- was staggering.

One of the bank holding companies had 38 banking subsidiaries. Of that number, fourteen had penetration rates of 80% or better. Four of the subsidiary banks had penetration rates of 100%.

The credit insurance activities of the other bank holding company were just as significant. It had 16 banking subsidiaries with a penetration rate of over 60%, of which ten had penetration rates of over 80% and one had a penetration rate of 98.8%.

Was this success based on a better price? No, not at all. As one judge wrote, the evidence revealed "the spectacle of an extremely successful 'sales program' peddling overpriced coverage to a captive market." Independent Insurance Agents of America, Inc. v. Board of Governors, 736 F.2d 468, 474 (8th Cir. 1984) (Ross, J., dissenting).

We are aware of no empirical investigation conducted in the years since that disproves the obvious point that banks will strive vigorously -- and unfairly -- to link banking services with insurance products.

The calculus of risks and benefits is obvious. There is no reason to believe that the market for the sale of insurance -- already very competitive -- will be improved by the entry of new competitors. But, because of the ability banks have to coerce their customers, either implicitly or expressly, the risk to consumers is great.

The proposal made by Mr. Corrigan, and the legislative language in S.1891 which would implement the essence of that proposal, recognizes that banks and bank holding companies require supervision and that, left unfettered, such banking institutions may engage in unfair practices. That is why both the Corrigan proposal and S.1891 distinguishes between banking services, financial services, and commerce.

The Corrigan proposal contemplates, however, the sale of insurance within the grouping of financial services. S.1891 takes a slightly different approach by investing a newly created Financial Services Oversight Commission with the ultimate responsibility for determining the type of activities permissible for holding companies. The accompanying summary of the bill does make clear, however, that bank holding companies would be allowed to "engage in a broad range of financial services."

S.1905, sponsored by Senators Cranston and D'Amato goes even further than S.1891. S.1905 would, as Senator D'Amato explained, "allow any type of business to engage in insurance, banking, securities and other financial service activities." The bill tries to lessen the adverse effects of these changes by allowing banks and bank holding companies to enter the insurance business only through the purchase of an existing insurance agency. In addition, it appears to us that the bill would prevent states from enforcing pro-consumer laws that are now on the books.

Insurance agency activities cannot be grouped with financial services and any new legislation should make this clear. Insurance agents are not the owners of giant financial service companies. We have not invaded the turf of banks and we do not have the capacity to do so. Expansion of banks into our business would not, therefore, "preserve competitive equity and enhance market efficiency," which is a statutory goal set forth in Section 2 of S.1891. We should not be sacrificed on the altar of deregulation.

In sum, we believe that the current system has worked well when federal regulators have not attempted to avoid congressional intent. We recognize the impetus to review the structure of the banking industry and we have no quarrel with it. A careful review, however, will demonstrate that Congress has kept banks out of the insurance agency business for good and sound reasons and that those good and sound reasons continue to justify retention of the strict limitations of the National Bank Act and the Bank Holding Company Act.

87-4118

To be argued by Jonathan B. Sallet

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.,
Petitioner,

v.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Respondent,

MERCHANTS NATIONAL CORPORATION, THE NATIONAL
ASSOCIATION OF CASUALTY AND SURETY AGENTS,
THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS,
THE NATIONAL ASSOCIATION OF PROFESSIONAL
INSURANCE AGENTS and THE NATIONAL ASSOCIATION
OF SURETY BOND PRODUCERS,
Intervenors.

**Petition to Review Order of the
Board of Governors of the Federal Reserve System**

BRIEF OF PETITIONER AND INSURANCE-AGENT INTERVENORS

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PRELIMINARY STATEMENT

This petition seeks review of an Order issued by the Board of Governors of the Federal Reserve System on September 10, 1987. *Merchants National Corp.*, 73 Fed. Res. Bull ___ (Sept. 10, 1987), *reprinted in* Joint Appendix ("J.A.") at 31-50. ("Board Order" or "Order"). The Board (i) ruled for the first time that a bank holding company is free through its state-bank subsidiaries to engage in the general sale of insurance, and (ii) held that the insurance moratorium created by Title II of the Competitive Equality Banking Act of 1987 does not bar issuance of its Order. [1]

STATEMENT OF ISSUES

1. Whether the limitations of Sections 4(a)(2) and 4(c)(8) of the Bank Holding Company Act of 1956, as amended, apply to the sale of insurance by a bank holding company through its wholly-owned state-bank subsidiaries.

2. Whether the insurance moratorium of Title II of the Competitive Equality Banking Act of 1987 bars issuance of the Board's Order.

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[1] For the Court's convenience, we have compiled an Addendum containing the statutes and regulations principally relied upon throughout this brief, including all statutory references to the newly-enacted Competitive Equality Banking Act of 1987. In addition, the Addendum includes a copy of the brief *amici curiae* filed by Senators Proxmire, Riegle, Dodd, Heinz, D'Amato and Shelby earlier in these proceedings in support of the petitioner's motion for a stay.

STATEMENT OF THE CASE

On September 10, 1987, the Board of Governors of the Federal Reserve System issued a novel and critically important order that breaches the longstanding legal barrier between banking and insurance. That order permits a bank holding company, through its ownership and operation of state-chartered banks, to engage in the general sale of insurance in a manner contrary to the express limitations of Sections 4(a)(2) and 4(c)(8) of the Bank Holding Company Act of 1956, as amended ("Act"), 12 U.S.C. § 1843(c)(8).

In 1986, Merchants National Corporation ("Merchants National"), a bank holding company and intervenor herein, sought the Board's permission to acquire two state banks in Indiana, both of which had previously engaged in general insurance activities. Merchants National proposed to acquire full ownership of both banks and to maintain them as wholly-owned subsidiaries. The Independent Insurance Agents of America, Inc., ("IIAA") and the insurance-agent intervenors opposed that application, contending that as a result of the acquisition Merchants National would be engaging in general insurance activities through those state-bank subsidiaries in violation of Sections 4(a)(2) and 4(c)(8) of the Act. The protestants thus raised the question of whether the so-called "South Dakota" loophole exists. That appellation derives from earlier plans of bank holding companies to sell insurance by means of their proposed acquisition of South Dakota banks, which were empowered under state law to engage in insurance activities.

In response to this protest, Merchants National voluntarily agreed to two divestiture conditions: *first*, that it would terminate the state banks' insurance activities completely within two years and, *second*, that during those two years it would not engage in any new insurance business. *See* J.A. at 24-25. The Board then approved the acquisition under Section 3 of the Act, 12 U.S.C. § 1842, without reaching the merits of the opposition lodged by the protestants.

In February 1987, Merchants National requested, *inter alia*, that the Board remove the divestiture conditions so that it would be free to sell insurance through these state-chartered banks. In March 1987, Merchants National amended that application. *See* J.A. at 26-27. The IIAA and insurance-agent intervenors again asserted that the use of state-bank subsidiaries to sell insurance would violate Section 4 of the Act.

On August, 10, 1987, while the request was pending, Congress enacted CEBA's insurance moratorium. Section 201(b)(3) of Title II, Pub. L. No. 100-86, 101 Stat. 552, bars the Federal Reserve Board from issuing any order that "would have the effect of increasing the insurance powers" of any bank holding company. Section 201(b)(4) specifically provides that the Board may not approve the "acquisition by a bank holding company . . . of any company, including a State-chartered bank, unless the bank holding company . . . agree[s] to limit the insurance activities in the United States of the company to . . . those permissible under section 4(c)(8)."

On September 10, 1987, the Board issued the Order that is the subject of this petition for review. First, the Board concluded that, as a general matter, "the nonbanking provisions of section 4, do not apply to limit the direct activities of holding company banks . . . ." J.A. at 37 (emphasis in original). The Board specifically held that the language of Section 4(a)(2), which states that no "bank holding company" may "engage" in an activity not permitted in Section 4(c)(8), applies only to the direct activities of a bank holding company and not to activities conducted through its banking subsidiaries. The Board based this conclusion on its view that IIAA's reading of the statute would render other portions of Section 4(a) superfluous, and on its belief that adoption of the protestants' position would interfere with the current system of dual regulation by federal and state authorities over banking institutions. Id. at 41. The Board's holding was not, however, absolute. The Board stated that it has authority to regulate the insurance activities of state-chartered banking subsidiaries in circumstances that demonstrate "an evasion of the Act." Id. at 39.

Second, the Board concluded that CEBA does not bar issuance of its Order. The Board acknowledged that the purpose of the insurance moratorium is to prevent the Board from deciding the precise issue -- whether the so-called "South Dakota" loophole exists -- resolved in its Order. The Board nonetheless asserted that its Order did not fall within the specific requirements set forth in Sections 201(b)(3)&(4).

On September 17, 1987, the IIAA filed its petition for review and immediately requested that this Court issue a stay of the Order pending judicial review. A bipartisan group of Senators who serve on the Senate Banking Committee (Senators Proxmire, Riegle, Dodd, Heinz, D'Amato and Shelby) filed a brief amicus curiae supporting the IIAA's motion. See Addendum of Petitioner and Insurance Agent Intervenors at 16. Following oral argument on October 6, 1987, a stay was granted.

SUMMARY OF ARGUMENT

Since the establishment of the national bank system in 1864, Congress has implemented a national policy of separating the business of banking from the business of commerce. See, e.g., National Bank Act, ch. 106, § 8, 13 Stat. 101; Glass-Steagall Banking Act of 1933, §§ 16, 20, 21, 32, 48 Stat. 162, codified at 12 U.S.C. §§ 24, 377, 378 and 78. In 1956, with passage of the Bank Holding Company Act, Congress expanded the focus of that principle from individual banks to bank holding companies; entities that, as a result of their ownership of a bank, are capable of combining banking and nonbanking activities within their holding company structure.

The decision to separate banking and commerce reflects Congress' careful judgment of how the public interest can best be served. The stability of banking institutions is furthered if they are limited to banking activities. And, without regard to the specific nature of the nonbanking activity, Congress has recognized that consumers and potential competitors alike are best protected from unfair and anti-competitive practices if banking institutions cannot combine banking and nonbanking services. Recently Congress acted to ensure the primacy of its role in this policy-making process by enacting an insurance moratorium to block administrative expansion of bank powers until Congress has had the opportunity to study further whether any reform of banking laws is needed.

Both facets of the Board's September 10th Order are invalid because, in each instance, the Board has chosen to ignore the clear intent of Congress by permitting Merchants National, a large bank holding company, to evade the express proscription of Section 4(c)(8) through the convenient vehicle of its new state-bank subsidiaries. See Chevron v. Natural Resources Defense Council, 467 U.S. 837 (1984).

Initially, the Board's refusal to apply the limitations of Sections 4(a)(2) and 4(c)(8) to the insurance activities of the applicant's state-bank subsidiaries must be judged to be incorrect. First, the plain language of Sections 4(a)(2) and 4(c)(8), as well as their accompanying provisions, demonstrates that the Board has erred by permitting Merchants National Corporation, a "bank holding company," to "engage" in impermissible insurance activities. Section 4(a)(2); 12 U.S.C. § 1843(a)(2). Second, the Board's own regulations and past actions have swept broadly to include both banking and nonbanking subsidiaries. Third, examination of the legislative history from 1956, 1966, 1970 and 1982 demonstrates that Congress quite explicitly intended that Sections 4(a)(2) and 4(c)(8) apply to all subsidiaries of a bank holding company. Fourth, the Board's attempt to rely on the "dual banking" system to justify a different result is ineffectual. The Board fails to recognize that the precise purpose of the Act was to limit the activities of companies that own banks, even state banks, but that the precise result of the Board's Order is to open a pathway through which bank holding companies can evade the specific limitations of Section 4(c)(8) whenever they wish.

In any event, the Board was without authority to issue its Order. The insurance moratorium enacted as part of Title II of CEBA bars the Board from issuing any order that has the "effect" of increasing the insurance powers of a bank holding company and from approving the "acquisition" by a bank holding company of any state-chartered bank engaged in insurance activities unless the bank holding company has agreed to abide by the limits of Section 4(c)(8). The Board's Order is governed by both provisions because its effect is to increase the insurance powers of Merchants National and because it permitted the acquisition of general insurance activities beyond the permissible scope of Section 4(c)(8). Moreover, as the Board itself has recognized, the purpose of the insurance moratorium is to close the so-called "South Dakota" loophole during the moratorium period, J.A. at 47, and the effect of its decision was to declare that loophole available for use by any bank holding company. Indeed, as Senator Heinz, one of the sponsors of the insurance moratorium, recently stated: "In a time of economic uncertainty, it is particularly important that elected

Representatives, not unelected regulators, debate and decide the important issues that lie ahead." 133 Cong. Rec. S14909 (daily ed. Oct. 22, 1987).

ARGUMENT

I.

SECTION 4 OF THE ACT APPLIES TO THE INSURANCE ACTIVITIES OF STATE-BANK SUBSIDIARIES OF BANK HOLDING COMPANIES

The Bank Holding Company Act is designed to restrain those companies that voluntarily subject themselves to federal regulation through their acquisition and operation of a bank, whether chartered by states or by the United States. See 12 U.S.C. § 1841(c). Since initial passage of the Act in 1956, Congress has recognized that the resulting entity, labeled a "bank holding company," see 12 U.S.C. § 1841(a), must be restricted to banking activities or to activities that are "closely related" to banking. Section 4(c)(8), 12 U.S.C. § 1843(c)(8).

The original and continued purpose for the nonbanking limitations on bank holding companies is clear. Congress believes the combination of banking and nonbanking functions within a single corporate entity would permit banking institutions (i) to tie banking services, like loans, to the purchase of nonbanking services, like insurance, (ii) to obtain an unfair competitive edge over nonbanking businesses with whom the banking institutions wished to compete, and (iii) to endanger the security of the banking system. *See* text at 23-25 *infra*.

These strands form a single thread. Congress "intended to implement a congressional policy against control of banking and nonbanking enterprises by a single business entity." *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 46 (1980). That remedial purpose must be construed liberally in order to effectuate Congress' basic purposes. *See Cliquot v. United States*, 3 Wall. 114, 145 (1866); *Pittston Stevedoring Corp. v. Dellaventura*, 544 F.2d 35, 51 (2d Cir. 1976), *aff'd sub nom. Northeast Marine Terminal Co. v. Caputo*, 432 U.S. 249 (1977).

In contravention of that principle, the Board's Order would import into the Act unsupportable distinctions that would exalt form over substance. Although a bank holding company cannot buy an insurance agency or hire an insurance agent, the Board's Order would permit the bank holding company to acquire and operate a bank that runs a full-scale insurance business. That distinction would force the scope of the Act's nonbanking prohibitions to turn on the mechanics of intra-company organization which are, of course, controlled entirely by the bank holding company itself. Because the Board's interpretation is applicable to all nonbanking activities, including securities and real-estate investment, the Board Order essentially grants bank holding companies the right to choose whether they will comply with the restrictions of Sections 4(a)(2) and 4(c)(8).

Evidence of the Board's erroneous interpretation of the Act rests, however, on no single principle of statutory construction. Rather "the terms, structure, legislative history and purpose of the Act make clear that a bank holding company may not avoid the nonbanking restrictions of the Act by conducting these activities through a subsidiary bank." Citicorp (South Dakota), 71 Fed. Res. Bull. 789, 792 (1985) (Governor Rice, concurring). In other words, the Act "restrains banks and bank holding companies from entering into unrelated business pursuits." Connecticut Bankers Ass'n v. Board of Governors, 627 F.2d 245, 249 (D.C. Cir. 1980) (emphasis added).

A. The Language Of The Act Demonstrates That Section 4(a)(2)(B) Governs The Nonbanking Activities Of Banking Subsidiaries Of Bank Holding Companies

The plain language and structure of the Act demonstrate Congress' concern with both the ownership of subsidiaries and the activities in which they engage. Following provisions in Sections 3 and 4(a) that govern the acquisition of subsidiaries, see 12 U.S.C. §§ 1842 & 1843(a)(1)&(2), Section 4(a)(2) states that "no bank holding company shall . . . engage in any activities other than (A) those of banking or . . . (B) those permitted under [Section 4(c)(8)]," 12 U.S.C. § 1843(a)(2).

The Board's analysis rests on the conclusion that Congress, in using the phrase "bank holding company" and the term "engage" in Section 4(a)(2), intended the provision to apply to activities engaged in only directly by the parent bank holding company itself and not indirectly through an affiliate or subsidiary thereof. That crabbed reading finds no support in the plain language of Section 4(a)(2) or in the accompanying provisions of the Act. [2]

First, the Board Order ignored the plain language of the Act. Section 4(a)(2) provides, in relevant part, that no "bank holding company" shall "engage" in any activity declared impermissible by Section 4(c)(8). 12 U.S.C. § 1843(a)(2). Section 4(c)(8) states that bank holding companies may engage in nonbanking activities that are "closely related" to banking, but expressly provides, with exceptions not relevant here, that no bank holding company shall act as an insurance agent. 12 U.S.C. § 1843(c)(8).

The application of Section 4(a)(2) to the instant case is obvious: Merchants National is unquestionably a bank holding company that would be permitted "to begin and carry on an enterprise" expressly declared impermissible by Section 4(c)(8). Webster's New Collegiate Dictionary, 378 (1973) (definition of "engage").

The Board objects to this characterization of Section 4(a)(2) on the ground that it renders the opening provisions of the section, which deal with the ownership of nonbanking subsidiaries, superfluous. Of course, it does not. Congress' choice to focus on ownership of banks in Section 3, to define permissible ownership of nonbanking subsidiaries in Section 4, and then, more generally in Section 4, to limit participation by bank holding companies in nonbanking activities simply establishes Congress' intent to establish a "catch-all" provision in the event that, as here, a bank holding company attempts to evade the limitations of the Act through means other than the ownership of a nonbanking company. It is "of course, a familiar canon of statutory construction that such clauses are to be read as bringing within a statute categories similar in type to those specifically enumerated." FMC v. Seatrain Lines, Inc., 411 U.S. 726, 734 (1973). See also Berger v. Bishop Investment Corp., 695 F.2d 302, 310 (8th Cir. 1982) (general catch-all clause intended to duplicate remedies available under other clauses of statute); United States v. Conforte, 624 F.2d 869, 880 (9th Cir.), cert. denied, 449 U.S. 1012 (1980) (general catch-all clause overlaps specific clauses).

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[2] The Board itself, on the one prior occasion that it ruled on an application to sell insurance through a banking subsidiary, characterized the bank holding company's effort as one "to engage in insurance activities prohibited for bank holding companies under section 4." *Citicorp (South Dakota)*, 71 Fed. Res. Bull. 789, 791 (1985). *See also* Application to the Board of Governors of the Federal Reserve System by Merchants National Corporation, *reprinted in* J.A. at 12-23 (Merchants National seeks "approval [under Section 4] to engage directly or indirectly in certain nonbanking activities").

Second, Section 4(c)(8) itself demonstrates that the Section 4(a)(2) reference to activities engaged in by a "bank holding company" refers to the bank holding company and all of its subsidiaries -- what the Board has referred to as the "bank holding company system." 12 C.F.R. § 225.128 (1972). In this regard, Section 4(c)(8)'s use of the term is especially important because its prohibitions are expressly incorporated into Section 4(a)(2).

Section 4(c)(8) begins by using the same term, "bank holding company", as Section 4(a)(2) to set forth the general prohibition on insurance activities. Section 4(c)(8) then explains that the term includes bank holding companies *and* their subsidiaries. For example, Exemption D, a grandfather provision, is generally applicable to insurance activities "engaged in by the bank holding company or *any* of its *subsidiaries*" on the grandfather date and Exemption F permits "insurance agency activity engaged in by a bank holding company, or *any* of its *subsidiaries*" so long as the bank holding company has total assets (including the banking subsidiaries) of under $50 million. *See* 12 U.S.C. § 1843(c)(8)(D)&(F) (emphasis added). By contrast, where Congress wanted to focus an exemption solely on certain types of subsidiaries, it did so expressly. *See* 12 U.S.C. § 1843(c)(8)(B) (permitting the sale of a certain type of credit insurance by any "finance company which is a subsidiary of a bank holding company"). Section 4(c)(8) contains no reference to "nonbanking" subsidiaries and, like Section 4(a)(2), no express exclusion of "banking" subsidiaries.

Examination of Section 4(c)(8)'s "public benefits" test yields the same conclusion. Section 4(c)(8) allows bank holding companies to engage in activities "closely related" to banking only if those activities are also in the public interest. *See National Courier Ass'n v. Board of Governors*, 516 F.2d 1229 (D.C. Cir. 1975). This "public benefits" test requires the Board to consider whether the performance of any activity "by an affiliate of a holding company" will serve the public. 12 U.S.C. § 1843(c)(8). In CEBA, Congress has recently amended the Act to provide expressly that an "affiliate" is "any company that controls, is controlled by, or is under common control with another company." Section 101(k). Were banking subsidiaries not governed by Section 4(c)(8), the term "affiliate" would have been defined in a more limited fashion. [3]

Third, 12 U.S.C. § 1850, adopted in 1970, demonstrates that Congress intended the term "engage" to maintain its plain meaning by applying to the activities of a bank holding company and all of its subsidiaries without regard to the specific means through which the activities are conducted. That provision, which establishes competitors' standing to challenge adverse Board action, expressly characterizes Section 4 as applicable whenever a bank holding company desires "to engage directly or indirectly in a nonbanking activity . . . ." Section 1850 is written in the broadest terms to include activities of all subsidiaries as well as the bank holding company; it contains no hint of a distinction between the permissible activities of banking and nonbanking subsidiaries. If Section 4 did not apply to the activities of banking subsidiaries, such broad language would be in error.

Fourth, the definition of the term "subsidiary" leaves no doubt that the Act does not distinguish between banking and nonbanking subsidiaries. Section 2(d), 12 U.S.C. § 1841(d), defines a "subsidiary" as a "company" owned by a bank holding company and the term "company" includes banks. *See* n. 3 *supra*. Further, the Board defines the term "subsidiary" to include a "bank or other company that is controlled by another company . . . ." 12 C.F.R. § 225.2(j). Thus, there is no conceivable reason not to treat banking and nonbanking subsidiaries alike in Section 4. 4/

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[3] Similarly, Section 4(c)(8) limits the acquisition of the shares in any "company" that engages in impermissible activities. The term "company" includes both banking and nonbanking organizations. See Section 2(b), 12 U.S.C. § 1841(b); 12 C.F.R. § 225.2(c)(1) ("'Company' includes any bank . . .").

Fifth, Section 7 of the Act defines the precise manner in which state regulators may interface with the Act's federal standards and that provision does not permit state regulators to override the Act's limitations. Section 7 provides that the Act shall not "be construed as preventing any State from exercising such powers and jurisdiction which it now has or may hereafter have with respect to companies, banks, bank holding companies, and subsidiaries thereof." 12 U.S.C. § 1846. Although that provision permits states to enact legislation more restrictive

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4/ In *Cameron Fin. Corp. v. Board of Governors*, 497 F.2d 841 (4th Cir. 1974), the court, deferring to congressional intent, interpreted a grandfather clause in Section 4(a)(2), which is not at issue in this case, in order to prevent the nonbanking activities of a banking subsidiary from escaping regulation, *id.* at 848, a policy entirely consistent with the view of the petitioner here. To reach that result, the *Cameron* court held that the term "subsidiary," as used in Section 4(a)(2)'s grandfather clause, did not include banking subsidiaries. On that specific point, the *Cameron* ruling has been superceded by the Board's Regulation Y, which specifically governs nonbanking activities and which includes a definition of "subsidiary" that expressly covers both banking and nonbanking subsidiaries. *Compare* 12 C.F.R. §225.1 (1983) *with* 12 C.F.R. § 225.2(j) (1984); *see also* 49 Fed. Reg. 818, 819 (Jan. 5, 1984). Moreover, in a decision subsequent to *Cameron*, the Ninth Circuit held that the term "subsidiary" as used in Section 4(a)(2) is, as we contend, governed by the definition of the term contained in Section 2(d)(3), 12 U.S.C. § 1841(d)(3). *Patagonia Corp. v. Board of Governors*, 517 F.2d 803 (9th Cir. 1975). It is not surprising, therefore, that the Board did not rely on the *Cameron* decision in the order under review.

than the Act, it does not permit them to "enact legislation inconsistent with the [Act] and therefore nullify its effect." S. Rep. No. 1095, 84th Cong., 2d Sess., pt. 2 at 5 (1956); S. Rep. No. 536, 97th Cong., 2d Sess. 41 (1982); Lewis v. BT Investments Managers, Inc., 447 U.S. 27, 48-49 (1980). The Board's interpretation would do exactly that; it would allow a state to "nullify the effect" of the Act simply by permitting its state banks to engage in any nonbanking activities otherwise prohibited by Section 4.

In sum, the plain language of Section 4(a)(2) and its accompanying provisions demonstrate that the nonbanking activities of all bank holding company subsidiaries are governed by the prohibition on insurance activities in Section 4(c)(8).

B. The Express Language Of The Board's Own Regulations Confirms That The Board Has Authority To Regulate All Nonbanking Activities, Whether Engaged In Directly Or Indirectly, By A Bank Holding Company

The Board's Regulation Y specifically "defines and regulates the nonbanking activities in which bank holding companies . . . may engage directly or through a subsidiary." 12 C.F.R. § 225.1 (emphasis added). As noted above, the Board has expressly defined "subsidiary" to include banking subsidiaries. *See* text at 15, *supra*. Thus, the limitations on nonbanking activities established by the Board expressly reach the banking subsidiaries of a bank holding company.

The Board is fully aware that the scope of its regulation is coextensive with the scope of Section 4(a)(2). Section 225.21(a)(2) clearly parallels Section 4(a)(2) by providing, as a general matter, that "a bank holding company *or a subsidiary* may not engage in . . . any activity other than . . . [a]n activity that the Board determines to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . ." (emphasis added.) *Compare* 12 C.F.R. § 225.21(a)(2) *with* 12 U.S.C. § 1843(c)(8). Section 225.25 follows with a specific list of activities that "may be engaged in by a bank holding company *or a subsidiary* thereof . . . ." 12 C.F.R. § 225.25 (emphasis added.)

These regulations alone demonstrate that the Board erred -- and failed to follow its own clearly-written regulations -- when it refused to apply the strictures of Section 4(c)(8) to the activities of a banking subsidiary. That conclusion gains further support from the Board's reaffirmation of its *Citicorp (South Dakota)* Order, its application of other provisions of Section 4(c) to the activities of state-bank subsidiaries and the Board's acknowledgment of jurisdiction to regulate the activities of nonbanking companies owned by state-bank subsidiaries.

1. The Board's Reaffirmation Of Its *Citicorp (South Dakota)* Ruling In The Proceeding Below Demonstrates That The Board Believes It Has The Jurisdiction To Control The Nonbanking Activities Of Banking Subsidiaries

The Board purports to have decided, as a general matter at least, that it has no authority to regulate the direct activities of state-chartered banks. But, in fact, a complete understanding of the Board's decision in *Citicorp (South Dakota)*, 71 Fed. Res. Bull. 789 (1985) and the Order under review demonstrates the Board's belief that it does have authority to apply the limitations of Section 4 to banking subsidiaries generally.

In 1985, the Board rejected an application filed by Citicorp to acquire a state-chartered bank in South Dakota that, under state law, was entitled to engage in nationwide insurance agency activities. The Board recognized that the proposed acquisition was simply a "device" to accomplish an impermissible objective: "permitting Citicorp to engage in insurance activities prohibited for bank holding companies" under Section 4. Citicorp (South Dakota), 71 Fed. Res. Bull. 789, 791 (1985) (emphasis added). Although the Board recognized that a bank holding company "engages" in activities that are directly undertaken by a banking subsidiary, see supra text at 16, the Board nonetheless asserted that it had not decided whether Section 4 authorized its ruling. Id. at n.6. Rather, it relied upon Section 5 of the Act. Id. at 790 n.3 (1985). See 12 U.S.C. § 1844.

Subsequently, the Supreme Court ruled that Section 5 has no substantive content and "only permits the Board to police within the boundaries of the Act. . . ." Board of Governors v. Dimension Financial Corp., 474 U.S. 361, n.6 (1986). In its September 10th Order, the Board nevertheless reaffirmed the result in Citicorp (South Dakota) and reiterated its intent to regulate the insurance activities of state-bank subsidiaries in circumstances it believes violate the purposes of the Act. J.A. at 49.

In the aftermath of Dimension Financial, the Board's view that it has authority to control nonbanking activities of banking subsidiaries can now rest only on Section 4. The flaw in the Board's analysis lies in its attempt to define *ab initio* what constitutes an "evasion" of the Act. J.A. at 39. Yet, Section 4(c)(8) expressly and with great specificity has already defined exactly what insurance activities are and what insurance activities are not permissible for a bank holding company. And Merchants National, like Citicorp, wishes to use the expedient of a state bank to accomplish an impermissible statutory objective.

The Board tries to distinguish the case from Citicorp (South Dakota) by contrasting the nature of the banking activities and the volume of insurance business. But that is a standard made from whole cloth designed to fit the current regulatory fashion worn by the Board. The distinction finds no support -- and it is significant that the Board cites none -- in the language or legislative history of the Act. Simply put, the Board's conclusion that it had jurisdiction over Citicorp (South Dakota) mandates the conclusion that it has the same authority here. And Section 4(c)(8), not some vague Board musings, provides the only standard against which the propriety of insurance activities may be measured.

2. The Board's Interpretation Of Other Provisions Of Section 4(c) Confirms That The Act Applies To The Nonbanking Activities Of State Bank Subsidiaries

Prior to the issuance of its Order, the Board had never held the insurance provisions of Section 4(c)(8) inapplicable to banking subsidiaries. But, without addressing the precise issue raised here, the Board has repeatedly affirmed that bank holding companies and _all_ of their subsidiaries are subject to Section 4.

The Board has, for example, expressly ruled certain nonbanking activities off-limits for banking subsidiaries of a bank holding company. In 1973, the Board ruled that courier activities meet the "closely related" standard of Section 4(c)(8), but that "[a] holding company courier subsidiary established under section 4(c)(8) should [nonetheless] be a separate, independent corporate entity, _not merely a servicing arm of a bank_." 12 C.F.R. § 225.129(a) (1973) (emphasis added).

Insurance regulations, too, have focused on the bank holding company as a whole. Thus, in 1972 the Board promulgated regulations designed to permit the "bank holding company system" to sell certain forms of credit insurance, _see_ 12 C.F.R. § 225.128(b)&(c); in 1976 the Board described the circumstances under which a "bank holding company" and its "affiliate" would be permitted to underwrite credit insurance. _See_ 12 C.F.R. § 225.135 (1976).

Finally, the Board has expressly interpreted other portions of Section 4(c) to apply to banking subsidiaries. In 1956, the year in which the Act became law, the Board confronted Section 4(c)(6), which provides that the prohibitions of Section 4(a)(2) generally shall not apply to the acquisition of less than five percent of the voting shares of a nonbanking company.

12 U.S.C. § 1843(c)(6). The question that quickly arose was whether the prohibition on ownership by the "bank holding company" required the Board to aggregate the shares held by the holding company and the shares owned by banking subsidiaries. The Board concluded that aggregation was appropriate, stating that "this exemption is as applicable to such shares when held by a banking subsidiary of a bank holding company as when held directly by the bank holding company itself." 12 C.F.R. § 225.101(c) (1956).

Similarly, in a regulation relating to investment company advisory activities, permissible under Section 4(c)(9), the Board defined "bank holding companies" to "include[] both their bank and nonbank subsidiaries." 12 C.F.R. § 225.125(c) (1972). Indeed, the Supreme Court in *Board of Governors v. Investment Company Institute*, 450 U.S. 46, 59 n.25 (1981), observed that this regulation, by "impos[ing] . . . *restrictions* on *banks*[,] prevented bank holding companies and their nonbanking subsidiaries from evading the restrictions by allowing subsidiary *banks* to perform the restricted activities." (Emphasis added.)

3. The Regulation Permitting State-Bank Subsidiaries To Engage In Nonbanking Activities Provides No Support For The Board's Order

The Board Order was careful to note that neither its reasoning nor its result is supported by the so-called state bank loophole which permits a bank holding company, through a subsidiary of a state-bank subsidiary, to engage in activities permitted under state law for free-standing state banks. *See* 12

C.F.R. § 225.22(d)(2)(ii). Rather, the Board Order stated that it would deal separately with the question of whether second-tier nonbanking subsidiaries are governed by Section 4(c)(8). J.A. at 46. [5]

For the purposes of this case, it is important simply to note that Section 225.22(d)(2)(ii) rests on the Board's belief that it has authority to regulate the banking subsidiaries of bank holding companies. In its original promulgation of the regulation in 1971, the Board was careful to explain that the exemption was based on its view of "considerations of equity" and that the regulation "will be reviewed by the Board from time to time in light of its experience in administering the Act." 36 Fed. Reg. 9292 (May 22, 1971). Recently, the Board has proposed that the regulation be amended in order to bar state bank subsidiaries from engaging in real estate investment activities, even if they are permitted under state law. See 52 Fed. Reg. 551 (Jan. 7, 1987). That proposal demonstrates the Board's continued -- and correct -- belief that it has the jurisdictional authority to override Section 225.22(d)(2)(ii) whenever it wishes. The exemption does not, therefore, provide any support for the Board Order under review here.

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[5] Petitioners and insurance-agent intervenors believe Section 225.22(d)(2)(ii) is invalid. See Security Pacific Corp., 72 Fed. Res. Bull. 800, 801 (1986). However, as the Board recognizes, Section 225.22(d)(2)(ii) is not at issue in this case because the question here is whether the Board has the authority to regulate the direct activities of a state-bank subsidiary, not whether the Board may ever exercise discretion to decline to exercise authority whose existence the Board recognizes.

C. The Legislative History Of The Bank Holding Company Act Demonstrates That Section 4 Applies To All Bank Holding Company Activities, Whether Engaged In Directly By The Holding Company Or Indirectly By A Banking Or Nonbanking Subsidiary

The legislative history of the Act confirms that Congress wished to regulate the nonbanking activities of the entire bank holding company system. Because Congress has consistently concluded that the combination of banking and nonbanking activities is against the public interest, its fundamental concern has been to protect consumers and potential competitors from banking institutions like Merchants National that wish to engage in nonbanking activities. That concern applies equally no matter which tentacle a bank holding company flexes when it wishes to sell insurance.

1. 1956: Congress Acted To Ensure That Banking And Commerce Are Not Commingled In Bank Holding Companies

Section 4 was enacted to "prevent the combining under the same management of both banking and nonbanking interests." 102 Cong. Rec. S6752 (1956) (Sen. Robertson quoting former Sen. Maybank).[6] *See also* H.R. Rep. No. 609, 84th Cong., 1st Sess. 11 (1955); S. Rep. No. 1095, 84th Cong., 2d Sess., pt. 2, 1 (1956). In enacting Section 4 in 1956, Congress emphasized the three reasons traditionally given for precluding banks from engaging in commerce.

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[6] Senator Robertson, Chairman of the Senate Committee on Banking and Currency which reported the bill to become the Act, was also the sponsor of the Senate bill and the single individual in the 84th Congress to whom most credit is due for adoption of the Act. His statements are due considerable deference. *See United States v. Oates*, 560 F.2d 45, 69-72 nn.25-28 (2d Cir. 1977) (statements of bill sponsors, floor managers and active participants in floor debate are "entitled to great weight").

First, Congress observed that banks are in a position to effectively condition the approval of credit on a customer's use of the bank's, or an affiliate's, commercial services. The tying together of banking and nonbanking services could lead to the express or implicit coercion of customers who, to protect their source of credit, would agree to use the commercial services. See S. Rep. No. 1095, 84th Cong., 1st Sess. pt. 1, 5 (1955).

Second, Congress feared that banks, by controlling credit, could eliminate competitors to their commercial activities. H.R. Rep. No. 609 at 16. In the words of Representative Spence, 7/ "[i]f you concentrate money and credit in the same hands, you have an impregnable monopoly. That is the effect of the holding companies today. Just imagine what chance you would have if you were a small-business man in a community where the holding company controlled the bank and also a competing business. There is no doubt about what would be your ultimate fate." 101 Cong. Rec. H8021 (1955).

Third, Congress recognized that unnecessary risks are presented to the security of the banking system when banks engage in commercial activities. Because these risks are ultimately

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7/ Representative Spence, Chairman of the House Committee on Banking and Currency, sponsored the House bill that became the Act. Like Senator Robertson, his statements are due extraordinary deference by the courts just as they undoubtedly received such deference from his congressional colleagues. See supra note 6.

underwritten by the public through state and federal insurance programs, Congress chose to reduce the risk of bank failure by regulating the activities in which bank holding company systems could engage. H.R. Rep. No. 609 at 4-5, 16 (chronicling failures of banks in holding company systems and identifying general policy); 102 Cong. Rec. S6943 (1956) (remarks of Sen. Morse noting threat to depositors' money).

Because Congress enacted Section 4 in order to protect customers and potential consumers from the adverse effect of impermissible nonbanking activities, it naturally emphasized the need to separate banking and nonbanking interests, rather than focusing on the internal mechanics of a bank holding company's organization. 8/ Thus, Section 4 was consistently described in both the House and Senate Reports as a provision to separate commercial and banking *interests*, *not* just commercial and banking *companies*. 9/

8/ Congress was well aware that some states, like today, permitted their state-chartered banks to engage in commercial activities. *See* H.R. Rep. No. 609, 84th Cong., 1st Sess. 4 (1955) ("*[m]ost* States restrict banks to the banking business") (*emphasis added*); 101 Cong. Rec. H3823 (1955) (statement of Rep. Spence quoting Address given by Speaker of the House Rayburn). Nonetheless, Congress enacted no language expressly exempting such states from the reach of the Act.

9/ *See also* H.R. Rep. No. 609 at 1 ("the need [to] force [bank holding companies] to divest themselves of nonbanking business has been established to the complete satisfaction of your committee"); *id.* at 11 ("it is the policy of the Congress . . . to separate the[ ] business of managing and controlling banks from unrelated business"); S. Rep. No. 1095, pt. 1 at 1 ("the bill . . . require[s] divestment of . . . nonbanking interests"); *id.* [y]our committee believes that bank holding companies ought not to manage or control nonbanking assets having no close relationship to banking"); *id.* at 2 ("bank holding companies would no longer be authorized to manage or control nonbanking (Cont'd)

Numerous statements made on the floor of both congressional houses by bill sponsors, reporting committee members, majority and minority leaders of the houses, and interested congressmen confirm the view that the activities of banking subsidiaries are governed by Section 4. The most significant colloquy, occurring between Senators Robertson and Thye, [10] demonstrates that the "closely related" standard of Section 4(c)(8) was intended to apply to all subsidiaries:

> Mr. Thye. Will the bill which we shall have before us tomorrow, with the committee amendments which were adopted en bloc this afternoon, provide that a holding company must divest itself of nonbanking business?
>
> Mr. Robertson. With this minor exception. Certain operations are . . . so closely related to the banking industry as to make it neither necessary nor desirable to force a bank holding company to give them up [such as] the operation of safety deposit boxes---
>
> Mr. Thye. Of course, that has been a customer's privilege in all the *banks* of which I have any knowledge. We certainly would not wish a *bank* to divest itself of *that sort* of business.

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assets"); *id*. at 4 ("the bill . . . requires divestment of their nonbanking interests"); *id*. at 5 ("[t]he bill's requirement for divestment of nonbanking assets will help to keep bank ventures in a field of their own"); *id*. at 14 ("[t]he divestment requirements in this bill are designed to remove the danger that a bank holding company might misuse or abuse the resources of a bank it controls in order to gain an advantage in the operation of the nonbanking activities it controls"); *id*. at 19 ("the operations of bank holding companies will not be prohibited, but they will be confined to banking activities and regulated in the public interest").

[10] *See supra* note 6. Senator Robertson was also the acting majority leader, and Senator Thye the acting minority leader, at the time of this colloquy.

> Mr. Robertson. *That is correct.* . . . So, we spell out a few exemptions and [let] [a] bank holding company . . . go before the Federal Reserve Board and say, "Here is an activity which is not technically banking, but it is so closely related to it that we think it should not be held to be a nonbanking *asset*," and the Board can act upon it.

102 Cong. Rec. S6761 (1956) (emphasis added). Statements of other congressmen equally directly reveal that Section 4 limitations on nonbanking activities apply to banking subsidiaries. 11/

11/ *See* 102 Cong. Rec. S6853 (1956) (Sen. Barkley) ("The object of the bill is to divorce *banks* and bank holding companies from the ownership and control of businesses other than banking, and to take their hands out of the treasuries and the management of industrial corporations.") (emphasis added); 102 Cong. Rec. S6940 (1956) (Sen. Douglas) ("For 18 years we have been trying to pass a bank holding company bill. Every bill which has been introduced has required *banks* to divest themselves of their nonbanking assets") (emphasis added); 101 Cong. Rec. H8022 (1955) (Rep. Cooper.) ("Mr. Chairman, I am supporting the pending bill . . . . As the distinguished chairman of the House Banking and Currency Committee and the other esteemed members of that great committee have informed you, the Bank Holding Company Act of 1955 prescribes circumstances under which *banks* are required to divest themselves of certain assets.") (emphasis added); 101 Cong. Rec. H8030 (1955) (Rep. Rains) ("Thus this recommendation of the Committee on Banking and Currency [is] to restore a greater measure of competition to banking, to restrict the business of banking to banks and to keep *banks* out of businesses in which they have no proper or even legal right to engage") (emphasis added); 101 Cong. Rec. H8033 (1955) (Rep. O'Hara) ("I do not think, however, that any of my colleagues will question the soundness of the rule that *banks* should stick exclusively to banking and should be as free of nonbanking interests as Caesar's wife from suspicion") (emphasis added); 101 Cong. Rec. H8035 (1955) (Rep. Multer) ("Now, if our principle is right that a banking business is a business peculiar unto itself and that those who engage in the banking business should not be interested in insurance companies, should not be interested in fishing companies, should not be interested in timber companies, should not be operating any enterprise except a banking business, then this bill must be enacted to effectuate that principle"); 101 Cong. Rec. H8184 (1955) (Rep. Smith) ("[N]o corporation engaged in the banking business ought to be permitted to also carry on at the same time unrelated businesses").

2. 1966: Congress Amends The Act To Eliminate Loopholes

In 1966 Congress enacted amendments to the Act to eliminate loopholes permitting bank holding companies to evade the limitations of Section 4. In the process of enacting this legislation, Congress expressly identified and addressed each exception that it found. Conspicuously absent from the congressional review is any mention of the so-called South Dakota loophole. See S. Rep. No. 1179 at 3, 5 (1966). See also 112 Cong. Rec. S12398 (1966) (colloquy between Sens. Lausche and Bennett identifying loopholes).

If Congress had believed that the South Dakota loophole existed, it would have been noted. While each identified loophole permits a limited number of bank holding companies to mix commerce and banking, the South Dakota loophole would permit each and every bank holding company to mix banking and commerce by simply acquiring a state-bank subsidiary entitled under state law to engage in commerce. Not a single reference throughout the 1966 legislative history suggests that the Act permits such a result.

Congress not only failed to discover the South Dakota loophole in 1966, but to the contrary it made perfectly clear its understanding that banking subsidiaries are not exempted from the Section 4 restrictions. Senator Robertson (the same Senator who was responsible for the 1956 Act, see supra note 6), upon introducing the 1966 bill, observed "the Bank Holding Company Act of 1956 imposed effective and meaningful restrictions on . . . the conduct of business within bank holding company systems."

112 Cong. Rec. S12380 (1966) (emphasis added). Later the same day, Senator Thurmond, a member of the Committee reporting the 1966 bill, reiterated this understanding, noting "the rationale underlying the [Act] is to prevent possible conflicts of interest and discriminatory favoritism between banks and private industries which are held under *some form* of common ownership." *Id*. at S12405 (emphasis added).

3. 1970: In Light of 14 Years Experience, Congress Clarifies and Expands The Scope of The Act

In 1970, Congress moved principally to address a loophole that it had identified, but left open, in 1966: bank holding companies exempt from the Act because they owned only one bank. In addition to extending the Act to one-bank holding companies, Congress revised the language of Section 4(c)(8), albeit in a manner that has no impact on this case. *See* H.R. Conf. Rep. No. 1747, 91st Cong., 2d Sess. 5 (1970) (setting out bill's revision to Section 4(c)(8)). Rather, the 1970 amendments are important for two reasons. *First*, Congress reiterated its belief that bank holding companies permitted to participate in unlimited nonbanking activities would have an unfair advantage over their nonbanking competitors. *Second*, two attempts were made to exempt some nonbanking activities from the scope of Section 4. The failure of both stands as clear and convincing evidence that Congress did not wish to exempt state-bank subsidiaries from the limitations of Sections 4(a)(2) and 4(c)(8).

a. The Single, Unifying Purpose of The Varied 1970 Amendments Was to Protect Small Businesses From Unfair Competition

A 1969 Presidential address, frequently referred to in the legislative history of the 1970 amendments, described the need to which the 1970 legislation responded:

> Legislation in this area is important because there has been a disturbing trend in the past year toward erosion of the traditional separation of powers between the suppliers of money -- the banks -- and the users of money -- commerce and industry.
>
> Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers.
>
> The strength of our economic system is rooted in diversity and free competition; the strength of our banking system depends largely on its independence. Banking must not dominate commerce or be dominated by it.

H.R. Conf. Rep. No. 1747 at 11-12 (1970) (quoting Presidential address of March 24, 1969).

Representative Patman [12] chronicled the dangers of mixing banking and commerce in holding companies, then noted:

> these problems are not theoretical or potential. . . . The [Committee] heard testimony . . . concerning the kind of pressure banks have exerted to gain customers for various departments of the bank . . . . Banks have been accused of requiring loan customers to furnish lists of their customers to the bank, and then the bank has used these lists to solicit business for the bank at the expense of their own customers. And a

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[12] Representative Patman, was the Chairman of the House Committee on Banking and Currency.

> subcommittee . . . heard . . . how *banks* can use their life and death power to grant or withhold credit to influence critical policy decisions of nonbanking corporations. . . . This is why the present situation requires the complete separation of banking activities from nonbanking activities.

115 Cong. Rec. H32894 (1969) (emphasis added). *See also*, *e.g.*, S. Rep. No. 1084, 91st Cong., 2d Sess. 3 (1970) (excerpting with approval the testimony of then-Federal Reserve Board Chairman Martin).

b. Congress Acted Specifically To Rebuff Attempts To Exempt Carve-Out Exceptions From The Reach Of Section 4

The final revisions to Section 4(c)(8), while not changing the wording of that provision significantly, involved dramatic maneuverings in both houses. When the dust settled, Congress had refused to accept any provision limiting the application of Sections 4(a)(2) and 4(c)(8) to all subsidiaries of bank holding companies. To accurately convey the 1970 legislative process, we address three phases separately.

1. *The House rejects a bill that would have exempted state-bank subsidiaries from Section 4*. The bill reported from the House Committee on Banking and Currency, H.R. 6778, did not expressly address the issue raised here. But the report of the Committee majority went out of its way to make clear that Section 4 does not apply to banking subsidiaries of bank holding companies. H.R. Rep. No. 387, 91st Cong., 1st Sess. 15 (1969). In introducing H.R. 6778 to the House floor, several Committee members adhering to these views repeated their understanding of

the narrow scope of Section 4. The Board relies primarily on these statements to support the proposition that Section 4 does not apply to banking subsidiaries. See J.A. at 42. [13]

But the House rejected the bill recommended to it. Under the leadership of Representative Patman, the floor completely rewrote H.R. 6778. [14] Among the amendments adopted on the floor was the Blackburn amendment. See 115 Cong. Rec. H33133-39 (1969). That amendment expressly rejected the Committee's "Prevailing View" that Section 4 does not apply to banking subsidiaries. Id. Representative St Germain, in explaining this provision, said "[t]he amendment . . . stat[es] clearly that no subsidiary of a bank holding company, *whether that subsidiary be a bank itself or another company*, may engage in the underwriting, sale, or distribution of shares in a mutual fund. . . . This amendment would make clear that this House does not want a *bank* to undertake an activity which its parent bank holding company may not undertake through the guise of its separate nonbank subsidiary." *Id*. at H33136 (emphasis added). 15/

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[13] Other than these statements, the Board relies on little in the legislative history for its novel reading of Section 4. Indeed, the only other citations are to (1) a 1970 Senate Hearing, (2) Reports on an unpassed 1980 bill (H.R. 2255), and (3) the Senate Report to the 1982 amendments. None offer much support for the Board. The statements in the Hearing, normally unentitled to much weight because they do not reveal the views of congressmen, see March v. United States, 506 F.2d 1306, 1314 n.30 (D.C. Cir. 1974), did not express the Senate's views in 1970. As we note below, see infra p. 34, the Senate Report to the 1970 bill cited only statements from its hearings that reveal that banks are governed by Section 4. Statements made in the 1980 Congress on an unpassed bill are entitled to minimal weight. United States v. Mauro, 544 F.2d 588, 594 (2d Cir.), cert. denied, 434 U.S. 816 (1976). Further, the Reports cited merely address that portion of Section 4 dealing with divestiture of nonbank subsidiaries. In fact, the 1980 Congress understood that Section 4 applied to bank subsidiaries. See 126 Cong. Rec. H14495 (1980) (remarks of Rep. Hanley noted "the central objection [to the bill includes that it] infringes on the open market actions of large banks which should be encouraged to diversify beyond simple banking"); id. at H14497 (remarks of Rep. Moorhead); id. at H14498 (remarks of Rep. Maguire); id. at H14536 (remarks of Rep. Patterson). The Senate Report to the 1982 amendments is misinterpreted. See text at 38-39 infra .

[14] This rejection was not unexpected. Due to parliamentary maneuvering, the Committee was precluded from considering alternatives to the bill reported. A number of Committee members explained in separate statements that they only voted for H.R. 6778 in Committee to get the bill onto the House floor.

Although the House rejected the attempt to exempt state-bank subsidiaries from the reach of the Act -- thus affirming the principle we urge here -- it did adopt a limited exception from Section 4 for insurance sold by banking

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15/ *See also id*. (remarks of Rep. Sullivan noting "[s]mall service businesses . . . should not be subjected to unfair competition from their major source of credit"); *id*. at 33137 (remarks of Rep. Chappell noting "it is absolutely right that the *banks* should not be operating in these particular business areas") (emphasis added); *id*. (remarks of Rep. Brown in opposition to Blackburn amendment noting "in effect, in this legislation, you are saying the banks so associated with holding companies cannot do some things, but other banks that are not associated . . . can").

Other debate on the House floor also revealed a common understanding that Section 4 applies to banking subsidiaries. Statements on the floor that the Act and its amendments do not apply to banks referred to unaffiliated banks, which are unregulated by Section 4, and not to banking subsidiaries, which are regulated. *See, e.g.*, 115 Cong. Rec. H32890 (1969) (remarks of Rep. Smith); *id*. at H32901-02 (colloquy between Reps. Patman and Stanton); *id*. at H32904 (colloquy between Reps. Hanna and Moorhead); *id*. at H33130 (remarks of Rep. Blackburn); *id*. (remarks of Rep. Gibbons); *id*. at H33130-31 (remarks of Rep. Matsunaga). This distinction has been continued in current law. *See* CEBA Section 201(e)(1) ("Nothing in this section shall be construed to deny any State the authority to permit its State-chartered banks *that are not controlled by bank holding companies* from engaging in any insurance activity.") (emphasis added).

subsidiaries. Id. at H33139 (adopting Blackburn amendment). But, as the subsequent discussion demonstrates, the full Congress rejected that attempt to create even a narrow "South Dakota" loophole.

2. The Senate emphasizes the broad reach of Section 4. The Senate version of Section 4(c)(8), like the House version, amended the Board's authority to determine what nonbanking activities are closely related to banking. The Senate bill did not, however, have a provision similar to the Blackburn amendment. Nonetheless, the Senate did understand that Section 4(c)(8) applies to the entire bank holding company system. First, the Senate Report quoted with approval those portions of the statements of FDIC Chairman Wille and Assistant Attorney General McLaren that expressly encouraged the Senate to expand Board flexibility under Section 4(c)(8) to approve the nonbanking activities of banks. S. Rep. No. 1084, 91st Cong., 2d Sess. 12-13 (1970) ("'[i]nasmuch as the economy and its financial requirements are constantly changing, the Corporation considers it essential that banks and bank holding companies have the flexibility to engage in new types of bank-related activities'") (emphasis added); id. at 13-14 ("'[t]here is a good economic case for providing greater flexibility as to the financial areas which banks and their affiliates are permitted to enter'") (emphasis added). Second, on the Senate floor, Senator Yarborough echoed the Senate Committee in observing:

> the purposes for the important bill [include] to impose some measure of control on the type of nonbanking activities bank holding companies and their controlled banks can

> engage in. . . . [I]n recent years large banks and commercial enterprises have used the one bank holding company as a device to gain control over commercial banks in various parts of the country and to involve banks in such non-banking activities as insurance . . . . The involvement of banks in such businesses not only present a conflict of interest between the bank and its customers who are involved in similar business activities, but also threatens the very existence of many small businesses.

116 Cong. Rec. S32114 (1970) (emphasis added). Similarly, Senator Phillip Hart noted that "a consistent purpose of our banking legislation has been the careful control of bank functions in order to protect the security of deposits, guarantee equality of treatment to all customers of a bank, and prevent the obvious anti-competitive dangers of bank influence upon nonbanking lines of commerce and the converse". Id. at S32116.

3. The Conference Committee rejects the House proposal to limit Section 4. The House and Senate bills were sent to the Conference Committee. The Conference Committee rejected the House suggestion that any exemption be made for state-bank subsidiaries. See H.R. Conf. Rep. No. 1747 at 5 (adopted Section 4(c)(8) does not exempt state-bank subsidiaries). Thus, the resulting legislation indisputably retained the underlying premise that banking subsidiaries are subject to Section 4. Floor debate that occurred immediately prior to passage of the

Act demonstrates Congress' clear understanding of this result. [16]

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[16] An important colloquy occurred between Representatives Brock and Reuss:

> Mr. Brock. Again, in order to assist me in clarifying the point, and perhaps to make a little legislative history as well, I think there is a possibility that when the conferees removed the laundry list, specifically that relating to insurance and insurance agents, from the prohibitions included in the bill, there could be an interpretation by some other person reading the language later on that we intended to allow banks to engage in the activities of an insurance agency. That would not be a fair interpretation of the action of the conference, would it?
>
> Mr. Reuss. I can categorically say that that interpretation would not be a fair interpretation. . . . If it is sought by the banking industry, for example, to get into insurance on a broader scale, then they should present their case to the Congress.
>
> * * * *
>
> Mr. Brock. The thrust, then, of the legislative intent of the conferees would be perhaps to allow a continuation of practices such as activities in the credit life insurance field, which are directly related to the banking function, and not in the field of general insurance whatsoever.
>
> Mr. Reuss. Certainly not in the field of general insurance.

116 Cong. Rec. H41962 (1970) (emphasis added). Representative Reuss was a member of the Conference Committee. Senator Bennett, a member of the Banking Committee, similarly noted on the Senate floor that "[t]he final result . . . retains maximum flexibility for the Federal Reserve Board to determine the activities in which a bank holding company and its subsidiaries may engage but at the same time protects those bank-related industries with which banks are allowed to compete from unfair competition by banks." 116 Cong. Rec. S42432 (1970) (emphasis added).

4. 1982: Congress Identified Insurance Agents As Particularly Susceptible To Anticompetitive Abuses And Expressly Limited Board Authority To Approve The Mixing of Banking and Insurance Sales [17]

The Garn-St Germain Depository Institutions Act of 1982 dealt with a broad range of issues across the spectrum of financial markets. In the course of this general overhaul of failings in the regulatory system, Congess devoted a specific title, Title VI, to "[r]estrict[ing] the insurance activities of bank holding companies." S. Rep. No. 536, 97th Cong., 2d Sess. 3 (1982); see also H.R. Conf. Rep. No. 899, 97th Cong., 2d Sess. 91 (1982). Title VI thus amended Section 4(c)(8) to provide, as a general matter, that "it is not closely related to banking or managing or controlling banks for a bank holding company to offer insurance as a principal, agent, or broker . . ." 12 U.S.C. § 1843(c)(8). That prohibition is followed by seven statutory exemptions, none of which are relevant here. See, e.g., 12 U.S.C. § 1843(c)(8)(A) (permitting the sale of credit insurance); see also n.16 supra.

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[17] The Act was also amended in 1978. The International Banking Act of 1978, Pub. L. No. 95-369, 92 Stat. 607 (1978). One of the primary objectives of that act was to provide for equal treatment of foreign and domestic banks operating in the United States. H.R. Rep. No. 910, 95th Cong. 2d Sess. 5 (1978); S. Rep. No. 1073, 95th Cong., 2d Sess. 2 (1978). Section 8 of that act extended Section 4 of the Bank Holding Company Act to, inter alia, the bank branches of foreign banks located in the United States. 12 U.S.C. § 3106. See also H.R. Rep. No. 910 at 7, 8, 13; S. Rep. No. 1073 at 15.

a. The Purpose Of Title VI Is To Protect Customers From The Anti-Competitive Tying By Banks Of Insurance Purchases To Credit

In enacting Title VI, Congress responded to studies over the course of fourteen years that demonstrated the undue power of banks to condition extensions of credit on the purchase of insurance. 128 Cong. Rec. S12222 (1982). Those studies "repeatedly documented the fact that credit tie-ins are commonplace." Id. Indeed, Congress was convinced that passage of Title VI would protect bank customers. As Senator Mitchell observed "this title benefits the consumer by protecting his or her ability to choose insurance services free from concerns over credit." Id.

b. The Legislative History Of Title VI Confirms That Banking Subsidiaries Are Barred Under Section 4(c)(8) From Engaging In Insurance Agency Activities

The 1982 amendments provide that bank holding companies, including all of their subsidiaries, may not sell insurance unless a specific statutory exemption is satisfied. See 12 U.S.C. § 1843(c)(8); text at 12-13 supra. The Board's Merchants National Order violates this straightforward mandate.

There is no doubt that Congress understood its revisions to Section 4 would apply to the entire bank holding company system. The Senate Report observes that the amendment "generally prohibits a bank holding company from providing insurance." S. Rep. No. 536, 97th Cong., 2d Sess. 37 (1982). See also id. at 71. The Senate intended the term "bank holding company" to refer to the entire holding company system.

Throughout the Report's discussion of the amendment, it unsystematically uses the terms "bank holding companies," "bank holding companies [and] their subsidiaries," and "bank holding companies and their nonbank subsidiaries" in referring to the scope of the amendment. See S. Rep. No. 536 at 37-42. The Senate drafters of the Report were not careless. The Report's indiscriminate use of both "bank holding companies," and "bank holding companies and their subsidiaries," confirms that "bank holding company" activities include the activities of both the bank holding company, itself, and the activities of the subsidiaries. The references to "bank holding companies and their nonbank subsidiaries" may reveal Senate recognition that Section 4(c)(8) wears two hats in Section 4; first, it governs the types of nonbank companies in which a bank holding company may own stock and second, it governs the activities in which bank holding company systems may engage. But, in any event, there is no evidence that by using the term nonbank subsidiaries, the Senate meant to legislate a revision of Section 4. Quite to the contrary, such a reading would contradict the language of the bill under consideration, 128 Cong. Rec. S12239, S12259-60 (1982) (bill adopted by Senate), and the Report's use of the term "bank holding company [and] any of its subsidiaries." S. Rep. No. 536 at 39 (emphasis added).

Debate on the Senate floor is consistent with this analysis. Senator Brady proposed an amendment to the bill that would have permitted the sale of certain insurance through a bank holding company system if the purchaser were given a thirty day

The CHAIRMAN. Thank you very much, Mr. Bailey. We thank all you gentlemen for your very fine statements.

Now Senators have come in since we started. If any Senator has an opening statement, we'd be glad to have him go ahead.

Senator HEINZ. Mr. Chairman, I have no opening statement.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. No, Mr. Chairman.

Senator DIXON. Mr. Chairman, I ask that my statement be placed in the record.

The CHAIRMAN. Without objection, so ordered.

RATINGS OF PROPOSED LEGISLATION

Now, gentlemen, I'm going to ask each of you on a scale of 1 to 10, with 0 meaning you don't mind at all and 10 being all-out off of its head opposition, your degree of opposition to each of the bills that are before the committee.

First, the Proxmire-Garn bill; second, the Wirth-Graham bill; third, the Cranston-D'Amato bill.

Mr. Colton, from 0 to 10, where do you stand?

Mr. COLTON. Can I have a few minutes with my calculator here?

The CHAIRMAN. Well, we'll start off with the Proxmire-Garn bill.

Mr. COLTON. I think there we're about a 5.

The CHAIRMAN. About a 5, OK.

Mr. COLTON. Is 10 opposition?

The CHAIRMAN. Ten means terrible, get rid of it. For heaven's sake, don't try that under any circumstances. You don't want any part of it.

Mr. COLTON. I think we probably end up on the other two bills closer to an 8 or a 9. But quite frankly, I would say we do not view ourselves as expert on all aspects of the financial services industry, so on those aspects that we're involved in, we would rate the bills as I've stated.

The CHAIRMAN. Thank you. Mr. Googins.

Mr. GOOGINS. So as not to appear inflexible, Senator, I have an aggregate score of 28. [Laughter.]

The CHAIRMAN. Well, that means that one of them does a little better.

Mr. GOOGINS. I think that if you ever were to enact something that didn't preserve the banking and commerce wall, the D'Amato proposal is one that at least if you were to do anything there it gives a more level playing field for everybody to get into it.

The CHAIRMAN. So that's the one you give an 8 to and you give a 10 to the others?

Mr. GOOGINS. Yes.

The CHAIRMAN. All right. Then, Mr. Flynn.

Mr. FLYNN. In the order in which you requested, it would be a 5, 7½, and a 10.

The CHAIRMAN. OK. Mr. Olson.

Mr. OLSON. I guess I would say that we would be maybe a 6 on that. I should go the other way. It's probably a 5 or 4 on that. The real concern would be the parts that would repeal Glass-Steagall.

With reference to S. 1891, that would be a 7 or 8 at this point. It has positive positions, but we are still concerned about the common ownership of the banks, the thrifts and the securities firms. And S. 1905, a 10.

The **Chairman**. OK. Mr. Bailey.

Mr. **Bailey**. Mr. Chairman, in anything that Congress does, there is only one overriding question. That is, who are you trying to help? The only acceptable answer ever to that question is the consumer, the people.

In the absence of any experience on our part that the consumer is better served by the expansion of any banking powers, we would have to give a big 10 to every one of these three bills. [Laughter.]

I'm sure that comes as no great surprise.

The **Chairman**. All right, gentlemen. Now we know where you stand.

Mr. Bailey, on page 12 of your statement you observe that the D'Amato-Cranston bill would prevent States from enforcing proconsumer laws that are now on the books.

What are some of the laws that would be preempted by the Cranston-D'Amato bill?

Mr. **Bailey**. Let me find that on my page 12, if you will, sir, so I can refer back to that.

The **Chairman**. If you prefer to give that to us for the record, you can do that and let us know in the next day or two.

Mr. **Bailey**. I would prefer to do that.

The **Chairman**. That's fine.

WRITTEN RESPONSE BY MR. BAILEY TO SENATOR PROXMIRE'S QUESTION

Attached is an appendix excerpting laws from 24 States that protect consumers by limiting the affiliation between lending institutions and the insurance business. As the Arkansas statute explains, such laws help to "minimize the possibilities of unfair competitive and deceptive practices by lending institutions on their subsidiaries or affiliates. . . ." Ark. Stat. Ann. § 66-2810(2)(3). As a Federal judge recently stated in rejecting an Equal Protection challenge to a similar Pennsylvania statute, "Section 641 is just the sort of classification that State legislatures are permitted to make, indeed, must make if they are going to engage in meaningful economic regulation." *Ford Motor Company, et al.* v. *Insurance Commissioner*, C.A. No. 87-3241, Slip op., at 8 (E.D. Pa.).

cooling-off period in which to cancel the policy. In introducing his amendment, Senator Brady explained that the amendment was preferable to the Senate bill because it permits "banks" to sell insurance while protecting insurance agencies from unfair competition. 128 Cong. Rec. S12221 (1982). In opposing the amendment, Senator Mitchell expressed fear that "consumers will purchase insurance from banks simply to protect their source of credit." Id. at S12222 (emphasis added). Senator Brady withdrew his amendment. Id. at S12230.

The Conference Committee Report left no room for doubt. It explains that the revision "generally prohibits bank holding companies and their subsidiaries from providing insurance." H.R. Conf. Rep. No. 899, 97th Cong., 2d Sess. 91 (1982) (emphasis added). The Report, like the 1956 Act itself, fails to make any distinction between banking and nonbanking subsidiaries. The statement does, however, confirm that references to "bank holding company" activities in the Act apply to activities of the entire holding company system. The Conference Report observes that "[t]he conferees stress that nothing in this Title is intended to prevent the transferring of grandfathered insurance activities of a bank holding company to the parent company or any of its subsidiaries." Id. Thus, the conferees emphasized the very point made throughout this brief; activities of the bank holding company include activities engaged in throughout the bank holding company system.

C. The Existence Of The Dual Banking System Does Not Support The Board's Narrow Interpretation Of Sections 4(a)(2) and 4(c)(8)

The major focus of the Board's analysis is on the so-called dual banking system; the system under which states charter banks that are owned by bank holding companies. The Board contends that the framers of the Act intended state authorities to "remain as the primary regulator[s]" and that the Act was not intended to cover banking subsidiaries. J.A. at 42.

The legislative history discussed in detail above demonstrates that Congress did, in fact, intend all of the activities of a bank holding company to come within Section 4. And, for four additional reasons, invocation of the "dual banking system" fails to support the Board's extraordinary reading of the Act. First, our view of the statute respects the voluntary choice of any institution to be governed solely by state authorities. The limitations of Section 4 only apply where, as here, a company that has voluntarily chosen to be a bank holding company also voluntarily chooses to operate a state-chartered bank and voluntarily -- if illegally -- attempts to gain the financial advantage of operating a general insurance business engaged in impermissible insurance activities.

The application at issue demonstrates this point precisely. Here, Merchants National, a large Indiana bank holding company has simply discovered a circuitous route to avoid federal law by acting as if its state-bank subsidiaries are independent actors wishing to proceed under state law. But it is the federally-regulated bank holding company, not the state-chartered bank, that is the real party in interest; it is Merchants National that ultimately benefits from the illegal insurance activity. In other words, the Board's analysis incorrectly focuses on whether insurance activities are permissible for the state-bank subsidiary standing alone "and ignores the more fundamental question whether [the bank holding company] may acquire a company engaged in such activities." Maryland National Corp., 73 Fed. Res. Bull. 310, 313 (1987).

Second, because state banks, through the ownership of other banks, can themselves become bank holding companies, 12 C.F.R. § 225.2(b) (defines bank holding company to be "any company (including a bank)" that controls a bank), even the Board is forced to admit that Congress must have wished to restrain the nonbanking activities of certain state banks. The Board's apparent theory that Congress wished always to leave the regulation of the nonbanking activities of state banks to state authorities thus fails to satisfy even the Board's reading of the Act.

Third, applying the limits of Section 4 to state-bank subsidiaries does not deny state regulators their "primary" role. As the Supreme Court explained in Board of Governors v. Investment Company Institute, 450 U.S. 46, 59 n.25 (1980), only state regulators may affirmatively authorize state banks to engage in nonbanking activities, but Section 4 acts as a limitation on all subsidiaries of a bank holding company. The sole role given the Board is to further restrict bank activities to conform to federal policy. That role is consistent with general federal policy. See, e.g., 12 U.S.C. § 1829(a) (state nonmember bank insured with FDIC may not, e.g., deal in lottery tickets).

Fourth, the Congress, though it did not wish to displace all state authority to supervise state banks, also indicated no desire to enact meaningless legislation. As noted above, Section 7 strikes the desired balance between federal and state authority. See text at 15-16 supra. Yet, the Board's interpretation requires the extraordinary belief that Congress wished to permit bank holding companies to retain their status as creatures of federal law and yet simultaneously to opt out of disagreeable provisions of the Act with the acquiescense of state officials. There is no evidence to support the belief that Congress wished to permit the repeal of Section 4's nonbanking provisions on a state-by-state basis.

III.

THE BOARD WAS BARRED BY THE INSURANCE MORATORIUM FROM ISSUING THE MERCHANTS NATIONAL CORPORATION ORDER

Congress has been aware that the proponents of the South Dakota loophole contend that the Act does not regulate banking subsidiaries. In 1987, while it enacted legislation concerning the fate of nonbank banks and provided additional funding for use to save thrift institutions, Congress created an insurance moratorium, running from March 6, 1987 until March 1, 1988, that is designed "to close the so-called 'South Dakota loophole' during the moratorium period." J.A. at 47. See H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 148 (1987) ("[t]he prohibition is intended to ensure that a bank holding company cannot take advantage of the so-called 'South Dakota loophole' during the moratorium by contending that the insurance restrictions in Section 4(c)(8) do not apply to the activities of the holding company's subsidiary banks.") Congress was careful to state that passage of the moratorium sheds no light on whether the South Dakota loophole has or does exist. Section 201(e)(2).

The moratorium was enacted to provide Congress with time to consider difficult issues concerning the proper role of banks in the financial marketplace.[18] Indeed, Senator Proxmire concluded his introduction of the bill that became CEBA with these words:

> Should we fail to enact this ban, we will be signalling to American executives that Congress can no longer defend the barrier between banking and commerce. The barrier will be shattered. We will be confronted with lawmaking by disintegration, rather than deliberation.

Id. 133 Cong. Rec. S3802 (daily ed. March 25, 1987). *See also* 133 Cong. Rec. S14909 (daily ed. Oct. 22, 1987) (Sen. Heinz observed that wild market fluctuations of preceding week show why Congress, not the Board, "must be in the driver's seat" on financial market policy).

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[18] *See, e.g.*, 133 Cong. Rec. H6945 (daily ed. Aug. 3, 1987) (Rep. Pepper); *id.* at H6947 (Rep. Vento); *id.* at H6955 (Rep. St. Germain); *id.* at H6959 (Rep. Wylie); *id.* at S11202 (daily ed. Aug. 4, 1987) (Sen. Proxmire); *id.* at S11205 (Sen. Dixon); *id.* at S11206 (Sen. Shelby); *id.* at S11207 (Sen. Dodd); *id.* at S11212 (Sen. D'Amato); *id.* at S11213 (Sen. Grassley); *id.* at S3818 (daily ed. March 25, 1987) (Sen. Heinz).

The applicability of the moratorium to this case is critically important. Because the Board did not have the authority to issue the Order under review, that Order must be vacated. In other words, the merits of the "South Dakota" loophole are not properly presented to the Court for review.

A. Because This Order Has The "Effect" Of Increasing The Insurance Powers Of A Bank Holding Company And Its Banks, Section 201(b)(3) Bars Its Issuance

Section 201(b)(3) of CEBA bars the issuance of any order "having the effect of increasing the insurance powers of banks [or] bank holding companies beyond those expressly authorized . . . under [Section 4(c)(8)]." § 201(b)(3). There is no serious question that this language applies to the Board's Order. Prior to the issuance of the September 10th Order, Merchants National had no authority to engage in general insurance activities, either through its state-bank subsidiaries or otherwise. The two bank subsidiaries themselves were required to divest or terminate their insurance activities within two years and, during that period, to refrain from making any new sales of insurance. (J.A. at 34). The Board Order freed the bank holding company and its subsidiaries from these restraints and, therefore, had the "effect of increasing the insurance powers" of these entities.

The Board Order does not even attempt to dispute the conclusion that the insurance powers of Merchants National, a bank holding company, were increased. J.A. at 48.[19] Instead, the Board reads Section 202 of CEBA as inconsistent and controlling. Section 202 provides that the insurance moratorium does not

> prevent a Federal banking agency from issuing any rule, regulation, or order pursuant to its legal authority in existence on the day preceding the date of enactment of this Act to expand the . . . insurance . . . powers of banks or bank holding companies that are subject to the moratorium . . . if the effective date of such rule, regulation, or order is delayed until the expiration of such moratorium.

The Board Order first claims that Section 202 is inapplicable because the Order merely declines jurisdiction and "does not involve the exercise of any authority [the Board] has under the BHC Act to permit or to prohibit the conduct by banks or bank holding companies of insurance activities." J.A. at 49. The Board then concludes that, because Section 202 is inapplicable, Section 201(b)(3) also has no application.

The Board drew the wrong conclusion from its analysis. If Section 202 is inapplicable, then Section 201(b)(3), which does apply, must be held to govern this case. The Board has resisted this conclusion by contending that Section 202 and Section 201(b)(3) are coterminous and, therefore, that

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[19] The Board did contend, by reference to state law, that the insurance powers of the state banks had not been increased. That conclusion is both irrelevant, because Section 201(b)(3) applies to bank holding companies as well as their subsidiary banks, and wrong, because use of the word "effect" in Section 201(b)(3) reveals a focus on the practical ramifications of Board orders and not a theoretical analysis on whether state corporate powers had been broadened.

Section 202 is controlling. See Memorandum In Support of Opposition Of Respondent Board of Governors of the Federal Reserve System To Petitioner's Motion For Stay at 26 (citing 133 Cong. Rec. S3937 (daily ed. March 26, 1987)). The Board's sole citation to the legislative history does not support the Board's reasoning. Senator Breaux's statement, the apparent object of the Board's reference, does not discuss the interplay between Section 202 and Section 201(b)(3). 133 Cong. Rec. S3937 (daily ed. March 26, 1987). Nor does the Conference Report. H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 149 (1987).

The structure of the insurance moratorium also demonstrates that the two provisions serve distinct purposes. Senator Breaux did not propose that Section 201(b)(3) be amended; rather he offered, and Congress accepted, the addition of a separate provision. Thus, the genesis of Section 202 demonstrates that it was inserted as a separate provision to serve a separate purpose. As this Court has stated, courts will "prefer a construction which leaves to each element of the statute a function in some way different from the others." United States v. Dinerstein, 362 F.2d 852, 855-56 (2d Cir. 1966) (footnote omitted).

By contrast, the Board's reading simply renders Section 201(b)(3)'s command that no order be issued as entirely meaningless. That is in derogation of the familiar principle that "no statute ought to receive a construction that will render it nugatory. . . ." United States v. Tappan, 11 Wheat. 419, 426 (1826); see South Carolina v. Catawba Indian Tribe, 106 S.Ct.

2039, 2046 n.22 (1986); Colautti v. Franklin, 439 U.S. 379, 392 (1979).

In sum, the language and legislative history demonstrate that Congress drew a careful line between situations in which the Board acted pursuant to its authority, addressed in Section 202, and situations in which the Board took action outside its authority that had the effect of increasing insurance powers, which is governed by Section 201(b)(3). The rationale for the distinction is not hard to discern. Because Congress specifically wished to close the "South Dakota" loophole during the moratorium, see text at 43-44 supra, and because Congress knew that resolution of the "South Dakota" loophole question turned on an analysis of the scope of Section 4, see, e.g., 133 Cong. Rec. S2939 (daily ed. March 10, 1987) (remarks of Senator Heinz, member of the Banking and Commerce Committee in support of related legislation), Congress simply wished to bar any decision on the merits of the "South Dakota" question prior to the end of the moratorium.

B. The September 10th Order Permits the Acquisition Of State-Bank Subsidiaries In A Manner Expressly Prohibited By Section 201(b)(4)

Section 201(b)(4) bars the issuance of any order "approving . . . the acquisition by a bank holding company of . . . a State-chartered bank, unless the bank holding company agree[s] to limit the insurance activities . . . to those permissible under section 4(c)(8) of the Bank Holding Company Act." § 201(b)(4). The Board makes only one argument in support of its contention that this provision is inapplicable. According to the Board, the September 10th Order was not part of its approval of the "acquisition" by Merchants National of the two state-chartered banks. Rather, the Board says that the acquisition took place in 1986, before the effective date of the moratorium.

The Board's reading ignores the divisible nature of property rights. The focus of Section 201(b)(4) is on a particular kind of property interest: the acquisition by a bank holding company of the insurance business of a state-chartered bank. Although the Board did approve an acquisition in 1986, that approval did not permit the acquisition of the on-going insurance activity belonging to the state-chartered banks. It was not until the September 10th Order that Merchants National ever "acquired" the distinct property "right" to engage in unlimited insurance activities.

Even so, should this court see any ambiguity in the reach of Section 201(b)(4), the Section must be interpreted to bar the Order. An administrative interpretation cannot be upheld that is contrary to the clear intent of Congress. *See* *Chevron v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 862-63 (1984). Here, the express purpose of Section 201(b)(4) was to shut the "South Dakota" loophole, *see* text at 43-44 *supra*, yet there is no doubt that the Board Order flings that loophole wide open. As six United States Senators explained to this Court:

> The insurance moratorium is thus designed to assert the primacy of Congress in determining the course of future banking legislation. Only Congress, not an administrative agency

> nor, with all due respect, this Court, is in a position to examine freely both the legal and policy issues raised by the Board's Order.

Memorandum of Amici Curiae, Senators Proxmire, Reigle, Dodd, Heinz, D'Amato & Shelby at 6 (see Addendum at 16). This Court should honor that clear congressional intent by holding that the Board erred in issuing the Order under review.

CONCLUSION

For the reasons stated herein, the petition for review should be granted and the Board's Order should be vacated.

Respectfully submitted,

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The **Chairman**. Mr. Olson, you complain that S. 1886, the Proxmire-Garn bill, by requiring that new securities powers be exercised through a bank holding company affiliate "cuts State legislatures completely out of the area of securities powers for their State-chartered banks."

But the bill specifically allows a securities affiliate to engage in any securities activities. There's nothing more that the States can give in the way of new securities powers. So the question here is not one of powers but one of safeguards. The question is whether we will set up a grand competition in laxity in which banking regulators will whittle away whatever safeguards Congress lays down.

Why should we allow that to happen?

Mr. **Olson**. To restate the question, with reference to States' rights in that area?

The **Chairman**. That's right.

Mr. **Olson**. As I said earlier, Senator, I feel like the State legislatures have properly passed legislation providing securities powers to the banks in some areas that have been I think effective. I think the safeguards have been protected in that case. So I just feel like the provisions are there for them to accomplish that.

The **Chairman**. Well, they could still do it under this bill. I don't see how that's affected by our bill because we give them powers wherever they wish. My time is up.

Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

Mr. Googins, you were correct in reserving your right to have pleasure here because, unfortunately, I find all of your testimony totally predictable, boring, self-serving, and I've heard it for 13 years. I don't mean that personally, but it does get a little bit tiring when you see the marketplace change so dramatically and not one of you in any of your businesses are doing it the way you were 5 years ago.

I've been out of the insurance business now for 15 years. I am totally unqualified, Mr. Bailey, to be involved in it anymore because it has changed so dramatically. You, as a successful agent, understand what I'm talking about. You do, too, Mr. Googins.

STEP-BY-STEP APPROACH

So it's dramatically changed, and yet I hear the same testimony—"Don't do anything. I'm opposed to change because of my own self-interest." Mr. Colton talks about step-by-step. What's your definition of step-by-step? Is that one bill every decade like we've had so that even as young as you are you won't be head of the home builders anymore by the time we take the next step?

Mr. **Colton**. Do you want me to answer that?

Senator **Garn**. Yes, I do. That's a serious question. What is your definition of a step-by-step approach? To me, that's a euphemism for stall. That's the best way to appear responsible, to come before the committee and say:

> I want change. We want to do something, but let's do it so carefully, so thoughtfully. Let's have another 25,000 pages of testimony and a few more hearings and a few more different chairmen, and some day we'll do something.

What's your definition of step-by-step?

Mr. **Colton**. We would like to see action by Congress on specific expanded banking powers some time in 1988. The powers that NAHB would definitely include in that list are mortgage-backed securities. But you can go beyond that as far as mortgage revenue bonds, commercial paper, mutual funds, the kinds of things that were included in the legislation that passed the Senate in 1985. We supported your legislation then and we would continue to support those expanded powers.

We've really just raised specific concern about an area where we actually think there is substantial reason for safety and soundness that you should go slowly with respect to direct investment in real estate.

So that's what we mean by step-by-step.

Senator **Garn**. Mr. Bailey, do you favor repeal of McCarran-Ferguson?

Mr. **Bailey**. No, I do not favor repeal of the McCarran-Ferguson Act.

Senator **Garn**. In other words, for those who don't know, the insurance industry of which I was a member for a long time, has only State regulation. And you favor not letting the Congress or the Federal regulators into the insurance industry, correct?

Mr. **Bailey**. That's correct.

Senator **Garn**. I do, too, very strongly. Then on what basis do you and the independent insurance agents continue to come to Congress with a double standard and ask that we regulate State-chartered institutions?

Mr. **Bailey**. We've never asked that you regulate free standing State-chartered institutions.

Senator **Garn**. That's exactly what you're doing when you get into the so-called South Dakota loophole closure. In my original bill in 1984, we closed it for national banks, as it should be and I favor. But when you continue to go on to a State-chartered institution, then you are interfering with States' rights which I have always strongly objected to. And as a former insurance agent, it bothers me that the independent insurance agents can continue to go further than nationally chartered institutions and you're asking us, while you want the protection of McCarron-Ferguson, to interfere with the right of State legislatures to deal with banks chartered within their States. That's where we have a very, very distinct disagreement and have caused considerable problems between the insurance industry and one over the issue of States' rights—not the issue of national banks selling insurance.

So how do you justify getting involved and not being willing to lobby the State legislature of Texas if you don't want State-chartered banks to sell insurance?

Mr. **Bailey**. Sir, I would like to respond to that. I think there's probably no one that's any more of a States' rights advocate than I am and I think there is a very clear distinction in this regard.

We have never testified to the effect that we believe that the States should not have the right to regulate free standing State-chartered banks in any way that they want to, and they are perfectly permitted to give them whatever powers they wish to give free standing State banks.

But I would point out that when a State bank becomes a part of a holding company, that's a voluntary act. It's not something they are forced to do. They voluntarily merge with or sell out or become a part of a holding company. A holding company is chartered by the Federal Government and is regulated by the Federal Government. And it has been our contention the entire time that when they voluntarily cease to become just a State bank but they also then become a part of a holding company, they are and do become a part of the regulations of that holding company, and the Bank Holding Company Act clearly says that they cannot be involved in the sale of insurance.

Senator GARN. Mr. Bailey, I fully understand the legal distinction, but I disagree that because a holding company owns that State-chartered institutions that that makes a difference. It's still a State-chartered bank and I tried an amendment on the floor for a small modification even to say that a holding company that was totally domiciled within a State not be subject to the Dodd amendment, and your organization even fought that minor change when it was totally within the State.

So that may be your personal opinion, but in my opinion it is a violation of States' rights. My time is up on this round.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

PRIMARY OBJECTIVES OF FINANCIAL INSTITUTION REFORM

I apologize for having missed the formal presentation. I have been reading the remarks. I would like to ask what do you think should be the primary objectives of this committee's review of financial institution reform? What do you consider to be the principal problems as it relates to financial services generically and particularly as it affects your particular areas of interest?

Mr. COLTON. Just starting off from the perspective of the National Association of Home Builders, as I mentioned to Senator Garn just a moment ago, we would like to see some specific expansion of banking powers and have tried to work with the banking industry along those lines. The ones we've always identified were mortgage-backed securities, although we would certainly feel comfortable with others being included.

Our major concern with respect to the legislation before this——

Senator GRAHAM. I'm not asking you to respond to the specific legislation that's before us. Rather, what are the principal problem areas or areas of opportunity that should set the agenda of this committee's consideration of financial institution reform?

For instance, you focused your remarks primarily on the question of expanded competition in mortgage-backed securities. That would indicate that you feel that one of the problems is an inadequate range of choice in that particular securities area.

Mr. COLTON. That's right. Exactly. We have identified, because of our expertise, Senator, one major area of opportunity and one major area of concern. The area of opportunity is mortgage-backed securities and we feel that there is a lack of competition in that area. As we pointed out in our testimony, ten firms underwrite 96 percent of all of the mortgage-backed securities, and opening up competition in that area will provide significant benefits to the consumer.

Our area of concern really relates to the fact that the legislation before us does not define what a bank holding company affiliate would be able to do as it relates to real estate investment. And we are concerned about leaving that open to the regulator. It's a very technical area. It is one where we are certainly willing to consider some sort of definition, but we think that Congress ought to do that rather than the regulators.

Senator **Graham**. On that part of your statement, the inference would be that you might feel that the current authority of thrifts to engage in direct real estate development and investment activities was improvident and that maybe we ought to be reviewing that decision. That's an issue which on this panel we had some debate yesterday as to whether that was or was not a problem area.

Do you feel that the current authority which has been granted to thrifts to engage in direct real estate activities was a misguided decision?

Mr. **Colton**. We feel that the thrift institutions who have gotten significantly involved in real estate activity, especially those in economically troubled areas, have discovered that direct investment in real estate has a lot of problems and a lot of concerns, and has led to a number of the problems that I think we've seen in Texas and in the oil-related areas.

We have not called for an absolute rollback on real estate powers. We did support what the Federal Home Loan Bank Board did and what the Federal Home Loan Bank Board just extended. They basically said that there ought to be a limit on direct investment activity to 10 percent of their assets and that it ought to be limited even further based on the net worth of those organizations.

So we clearly feel that that is an issue which has serious safety and soundness considerations. And if Congress wants to get into that, we would be delighted to enter into a discussion and to talk about how to define these terms as far as thrift institutions are concerned.

Mr. **Flynn**. If we were to look at three principles on which to guide your deliberations on this matter, the first principle is that Congress, which is responsive to the electorate, should be the body to allow the institutions to expand their business opportunities and activities and not the regulators. They're an insulated group that's very difficult to touch or move and the Congress has an opportunity through the direct electorate to get to it.

Number two, the safety and soundness of the institutions have got to be primary and first and foremost because the integrity of the economy, the integrity of the capital system would be at risk.

And the third principle is that there not be unfair competition to the small business person, and I think that's the intent of the response of most of the people that are here.

Senator **Graham**. Mr. Chairman, my time has expired. If any of the other members of the panel would like to supplement their comments in writing on that subject, I would appreciate it.

The **Chairman**. Thank you. Senator Gramm.

Senator Gramm. Well, Mr. Chairman, let me begin by first making note that the Wirth-Graham bill is the other Graham. I begged him not to try to do those terrible things that you all are so hell-bent against. If I were doing this bill, each and every one of you would find something wonderful for your industry. [Laughter.]

I'd like to say that while I almost always agree with Jake Garn, I'm going to be very distressed when I come here some day and I hear the home builders and the Council of Life Insurance and the realtors and the insurance agents advocating anybody's interest besides their own. In fact, if you all don't advocate your interest, it's unlikely to be advocated anywhere around here.

Our problem is to try to distill all of your individual interests into some broadly defined public interest and I've always been looking for the fellow who spoke for the public interest and I have not found him yet.

I'd like to begin by just asking sort of a general question and let me phrase it as follows. As I look at the banking industry, we have seen in the last 20 years about as dramatic a change in that industry as has occurred in any industry in America. There used to be distinctions among savings and loans and credit unions and commercial banks and those distinctions, for all practical purposes, have been eliminated.

When I was teaching money and banking, I taught that banks did something unique, and that is they sold demand deposits and those demand deposits circulated as a medium of exchange and, therefore banks were creating money. Now, for all practical purposes, we've got institutions from credit unions to savings and loans to Sears & Roebuck that are involved in basically the money-creating industry.

We've seen the market share in terms of financial resources of the banking industry plummet in the last 15 years. And if you believe that a dramatic change of that nature at least ought to be looked at in terms of what is happening in terms of our financial market, how much capital in the banking industry, both human capital and financial capital, is trapped in an industry that is now seeing tremendous competition from outside the industry where there's nothing like any kind of level playing surface. That's got to be something that you've got to be willing to look at.

CURRENT BANKING LAWS

I want to ask two questions and I'll just start down here with Mr. Colton and just run down the line. Do any of you think that our current banking laws fit the reality of the financial marketplace and that we really ought not to change them?

Mr. Colton. No. We think it is appropriate to review those laws and to make changes. We just need to be careful in doing that to not do anything that we'll be sorry for later. But the marketplace has moved beyond where our laws are.

Mr. Googins. I'd like to echo that, although I think obviously you must be very careful in terms of what it is you do. But the most important thing I think this committee can do, however it comes out, whether in accord with our testimony or inimical to it, is to reach out and regrasp the establishment of national banking policy here, and not abandon it to the regulators.

Mr. **Flynn**. I, too, and our association would embrace having laws that keep pace with the changing economy, again, as long as the three principles I articulated to the question of a Senator here would be abided by. I think those principles are there and let the Congress do it, the safety and soundness, and unfair competition.

When we talk about level playing fields and the unlevel playing field that banks find themselves in, our concern is when they get in our kinds of business that now they're an 800 pound gorilla among people that are standing without this same kind of protection and background that they have.

Mr. **Olson**. Senator Gramm, I couldn't agree with you more that there's a need for change. I'd like to leave that message today coming from my association, that there's definitely a need for change in the banking industry.

I find myself in rural America almost totally dependent on agriculture in the bank I'm associated with. I have to develop new profit centers for my future for that financial institution to continue to exist in the banking business in that community which only has one financial institution. So I am very cognizant of that.

I think the new securities powers are needed, plus others. But again, we'll look at the safety net.

Mr. **Bailey**. Senator, I'm not unfamiliar with banking. I think you may well know I've served on the board of a national bank for 23 years and I've served on the executive committee of that bank for about the last 8 years.

There has been a great deal of change. There's been change both within what the banks themselves can do and also in what their competition has done through the thrifts and through the credit unions and other organizations.

For example, the banks were given the opportunity to pay interest on checking accounts. As most of us know, what actually happened in this situation is the banks found themselves in the position where they had to maintain their profits, so they placed minimums under which they did not pay any interest on those checking accounts, which removed from that benefit most of the smaller depositors of the banks. Moreover, to offset that interest they were paying to other people with checking accounts, the banks across-the-board increased the cost of all the services that they provide—such as the cost of checks and the cost of service fees, to make up for that. It is no secret what has taken place.

This new benefit that was given to banks supposedly to benefit the depositors, and particularly the small depositors, simply did not materialize.

There is a real problem the banks have in competing with the thrifts and competing with the various trade organizations, but I am still convinced that two wrongs do not necessarily make a right. They never have and they never will. I am concerned with the fact that we are now going to say, that in order to place the banks on an even footing with those institutions, we are now going to give them the opportunity to come out here and try to get into the business of small business people. It was alluded here today that independent insurance agents are not doing things the way we

APPENDIX

RELEVANT EXCERPTS FROM STATE CODES

Arizona	Ariz. Rev. Stat. Ann. § 6-465(A)(1986) "An association operating under this chapter and any other association or corporation, under whatever laws organized, except an association or corporation operating an insurance business, other than title insurance . . . may merge into one association operating under this title."
Arkansas	Ark. Stat. Ann. § 66-2810(2) (1981 Supp.) "The Commissioner shall not issue any Agent's license to any lending institution, . . . in any municipality within this state which has a population that exceeds five thousand [5,000], according to the latest United States decennial census. (a) Provided, however, such lending institution, . . . may [*inter alia*] be issued a license: (i) to sell mortgagor's decreasing term life insurance, mortgagor's accident, health and sickness insurance, credit life insurance, credit accident and credit health and accident insurance."

California	42A Cal. Ins. Code § 1643 (West 1986) "No bank, [and] no bank holding company . . . may be licensed as an insurance agent or broker or act as an agent or broker for insurance . . ., except that a bank or a bank holding company subsidiary, or affiliate of a bank may be issued a license to act as a life and disability agent limited to the transaction of credit life and disability insurance . . . This section shall not apply [*inter alia*] to any bank or bank holding company which, under the authorization of the Federal Reserve Board, had prior to January 1, 1976, a subsidiary or affiliate licensed to sell insurance (except that subsequent authorization to expand such activities shall be subject to this section), or to any bank holding company owning a state-chartered bank which had, prior to January 1, 1976, a subsidiary or affiliate licensed to sell insurance."
Cal. Fin. Code § 1208 (West 1968)	"A commercial bank located in a place the population of which does not exceed 5,000 persons . . . may act as agent for fire, life, or other insurance company authorized to do business in California . . . "

Colorado	Colo. Rev. Stat. § 10-2-221(2) (1983) "No bank or bank holding company, nor any subsidiary, affiliate, or employee thereof, shall be licensed or admitted, directly or indirectly, as an insurer or be licensed to sell insurance in this State . . . , except that [*inter alia*]: (a) A bank or a bank holding company . . . may be licensed to sell credit life and credit accident and health insurance . . . (b) A bank holding company . . . , in a municipality or trade area, the population of which does not exceed five thousand . . . may be licensed to sell insurance . . . (c) Any employee of a bank or bank holding company licensed to sell insurance . . . on July 1, 1977, may continue to do so . . ." § 11-6-101(2) (1983) "[A]ny bank, located and doing business in any community the population of which does not exceed five thousand inhabitants, . . . may, . . . act as the agent for any fire, life, or other insurance company . . ."

Connecticut	Conn. Gen. Stat. Ann. § 38-72a (West 1986) "(b) No license authorizing the sale of fire and casualty insurance shall be issued . . . to (1) a lending institution, or (2) a bank holding company . . . [except for licenses issued as of October 1, 1973]"
Florida	Fla. Stat. Ann. § 626.988(1)(a) (West 1984) "This definition [of financial institution] shall not . . . include [*inter alia*] any financial institution which has been granted an exemption by the Board of Governors . . . pursuant to § 4(d) of the Federal Bank Holding Company Act . . . . Specifically excluded [from this prohibition] . . . is any bank which is not a subsidiary or affiliate of a bank holding company and is located in a city having a population of less than 5,000 . . ." § 626.988(2) (West 1984) "No insurance agent . . . licensed by the department of insurance . . . who is associated with, . . . a financial institution shall engage in insurance agency activities as an employee . . . of a financial institution agency" [with certain exceptions set forth in the statute].
	§ 626.988(2)(a) (West 1984) "[A]n insurance agent . . . who is affiliated with . . . a bank holding company subsidiary, . . . may engage in insurance activities . . ., but only to the extent that such activities are directly related to extensions of credit . . . [S]uch agent may offer decreasing term life insurance."
Georgia	Ga. Code Ann. § 33-3-23 (1986) "(b) No lending institution [or] bank holding company, . . . may directly or indirectly be licensed to sell insurance in any municipality within this state which has a population which exceeds 5,000 . . . except that [*inter alia*] a lending institution . . . may engage in underwriting . . . credit life insurance and credit accident and sickness insurance . . ." "(f) [and statutory restrictions] . . . shall [not] apply to any lending institution . . . which was a subsidiary or affiliate of either of the foregoing on January 1, 1974 . . ."
Iowa	Iowa Code Ann. § 524.710 (West 1970) "No officer or employee of a state bank shall: . . . (3) [e]ngage, directly or indirectly, in the sale of any kind of insurance . . ."
Kentucky	Ky. Rev. Stat. Ann. § 287.030(4) (Michie 1986) "No person who after July 13, 1984, owns or acquires more than one-half (1/2) of the capital stock of a bank shall act as insurance agent or broker with respect to any insurance except [*inter alia*] credit life insurance [and] credit health insurance . . ."
Louisiana	La. Rev. Stat. Ann. § 22:1454 (West 1978) "No domestic insurer shall . . . engage in any banking business whatsoever."
Maine	Me. Rev. Stat. Ann. tit. 24-A, § 1514-A(2)(1983) "No financial institution . . . may be licensed as an insurance agent. . . . [with exceptions noted in the statute]."
Massachusetts	Mass. Gen. Laws Ann. Ch. 175, § 174E (West 1986) "No such [insurance] license . . . shall be issued to any bank unless such bank held such license . . . prior to October eleventh, nineteen hundred and seventy-two. . . ."

Mississippi	Miss. Code Ann. § 83-17-229 (1986) "No lending institution . . . or holding company located in any municipal corporation of this state which has a population of seven thousand (7,000) persons or more . . . may directly or indirectly be licensed to sell insurance . . ., however, . . . the subsidiary or affiliate of a lending institution . . . may be licensed to sell credit life, health and accident insurance . . ."
Nebraska	Neb. Rev. Stat. § 44-392 (1986) "It shall be hereafter unlawful for any bank . . . located in any incorporated city in this state having a population of two hundred thousand or over, to sell, write or solicit any kind or form of insurance . . ."
Nevada	Nev. Rev. Stat. Ann. § 662.235(2) (Michie 1971) "No bank shall act as agent for any insurance company." § 683A.110(2)(1971) "No bank or bank holding company . . . may directly or indirectly be licensed to sell insurance in this state except as to credit life and health insurance and credit property insurance . . ."

New Hampshire	N.H. Rev. Stat. Ann. § 384:16-b(II) (1983) "[N]o bank or banking association . . . shall directly or indirectly engage in . . . the sale or servicing of policies of property or casualty insurance . . .; insurance consulting activities or performance of any other activity as insurance agents or brokers . . ."
New York	N.Y. Ins. Law § 2501 (McKinney 1985) "(a) No insurance agent or broker . . . who is owned or controlled, directly or indirectly, by a bank shall negotiate any policy of insurance covering real or personal property which is the subject matter of, or security for, a loan or extension of credit made by the bank . . ."
Ohio	Ohio Rev. Code Ann. § 3911.01 (Anderson 1985) "The business of life insurance, or life and accident insurance, in this state, shall not be in any way transacted by any company, partnership or association which in this state, or in any other state or country, . . . does a banking or any other kind of business in connection with insurance."

Puerto Rico	P.R. Laws Ann. tit. 26 § 304 (1985) "To qualify . . . to transact insurance in Puerto Rico an insurer must: (7) [c]omply with the following additional qualification []: (a) [t]hat no bank, . . . except companies engaged exclusively in the financing of individual insurance premiums . . . [can] own or control a substantial part of the shares of the insurer." § 307 "No person shall be authorized as an insurer in Puerto Rico if he engages in any business other than the insurance business . . ."
Rhode Island	R.I. Gen. Laws § 27-3-47 (1979) "Except for [*inter alia*] the sale of credit life insurance [and] credit accident and health insurance . . . no license to act as an [insurance] agent . . . shall be issued to . . . a bank, savings bank or trust company . . . a bank holding company [or] any other individual, corporation, partnership or association authorized to take deposits and to make loans of money. . . ."

Tennessee	Tenn. Code Ann. § 56-6-201 (1986) "(a) No insurance agent . . . who is owned or controlled directly or indirectly or who is employed by a bank holding company . . . shall negotiate any policy of insurance other than [*inter alia*] credit life insurance [and] credit accident and health insurance . . ."
Texas	Tex. Ins. Code, Art. 21.07-3, Sec. 5(h) (1981) "Except as provided herein, [an insurance] licensee that qualifies under this section may not be owned in whole or in part, either directly or indirectly, by a state bank, national bank, or bank holding company. . . . This subsection shall not apply to any licensee that on June 1, 1981, is owned by a state bank, national bank, or bank holding company . . .

so long as ownership continues; nor shall this subsection apply to a licensee for which on July 15, 1981, a state bank, national bank, or bank holding company . . . filed an application for prior approval of ownership . . ."

ermont

Vt. Stat. Ann. tit. 8, § 4811 (1984)
"(a) No lending institution may directly sell, negotiate or service insurance in this state, except [*inter alia*] credit or mortgage life insurance . . ."

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Va. Code Ann. § 38.2-206 (1986)
"A. No lending institution, [or] bank holding company . . . doing business in this Commonwealth, or any officer or employee, excluding a director of any of these institutions, shall be directly or indirectly licensed to sell insurance if located in any county, city or town in this Commonwealth that has a population exceeding 5,000 persons . . ."

"C. Nothing in this section shall apply to (i) any lending institution . . . licensed to sell insurance . . . on January 1, 1977 . . ."

used to do. That is not necessarily true. Sure, we have given numerous extensions of insurance programs. We use package policies. We use computers. But we still insure cars and we still insure homes and we still insure lives and we still insure businesses.

These are the same things that banks extend credit to—credit on the homes and autos and lives and businesses. And we are very concerned about the problem that this can create and the power that banks have in this regard. We think it is a mistake and we do not think this will be the proper action to take.

Senator GRAMM. Well, Mr. Chairman, my second and final question would have set out a blueprint for our legislative policy for the remainder of the decade, but I'm out of time. [Laughter.]

The CHAIRMAN. We will put your blueprint in the record. [Laughter.]

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Let me thank each one of the witnesses here for the thoroughness with which they have put together their presentations.

I'm going to start with you, Mr. Olson. You say in your statement that you support a step-by-step approach to granting banks additional securities powers rather than repeals of key sections of the Glass-Steagall Act.

I'd like each of you to comment on—and I'm going to start with you because I'm using your reference here—I'd like each of you to address the question of repeal of Glass-Steagall. I know you've talked about it in your presentations but I want to have a summary comment from each of you side by side on what you think ought to be done about Glass-Steagall at this point. Let's start with you, Mr. Olson.

THOUGHTS ON REPEAL OF GLASS-STEAGALL

Mr. OLSON. With reference to the repeal of sections 20 and 32 of Glass-Steagall, it would in fact permit the mergers, the purchase of banks by securities firms and vice versa. Our concern is it does create more of a concentration in both the financial and the securities areas. That is a real difficult part for us because I look at the ability to retain the deposits and more importantly I must think about what's good for my customer. I can't really see where that is beneficial to the customer in terms of competition. So that's why I would oppose the repeal of those two sections.

Other than that, expansion of powers, obviously we would be very supportive.

Senator RIEGLE. Mr. Bailey.

Mr. BAILEY. Well, our position has always been and still is that we are opposed to expanded powers for banking.

I know there was some testimony here the other day, a spokesman from the ABA said that over the short run it is important for Congress to concentrate on the issues of securities powers for bank holding companies leaving areas of insurance and real estate and the question of comprehensive reform for a later consideration.

We view this primarily as an opportunity to break down the various segments of the industry and perhaps act on them one at a time, which we find not in our best interest and we are not for that.

Senator RIEGLE. Mr. Flynn.

Mr. FLYNN. Our association doesn't have a direct policy regarding Glass-Steagall. I think on balance we would oppose the repeal of it. However, we will submit a written response to it once we review it in more detail.

[The following was subsequently submitted for the record:]

Senator RIEGLE. Mr. Googins.

Mr. GOOGINS. Senator, since we have opposed anything that would dismantle the separation between banking and commerce, obviously that applies to Glass-Steagall as well.

Indeed, as a result of recent events, we think it's the very existence of Glass-Steagall that probably allows this country, notwithstanding those events, to be in as good a shape today as it is.

Senator RIEGLE. Mr. Colton.

Mr. COLTON. NAHB has not taken a specific position on the repeal of Glass-Steagall. Just speaking as a pragmatist, I do not think within the next year that's going to happen. So what I would like to see Congress do is focus on those kinds of expanded powers which can pass both the House and the Senate within the time period available.

Senator RIEGLE. All right. Now let's take that and go right back down the table. Specifically, what expanded powers do you think ought to be granted at this point?

Mr. COLTON. As an association, we have supported mortgage-backed securities powers for banks and thrifts and would advocate banks being able to have mortgage-backed securities powers directly.

We have also indirectly advocated a larger basket of investments like mortgage revenue bonds and commercial paper as investments we feel comfortable with banks being involved in.

Senator RIEGLE. And is that the list? I mean, what happens when you get beyond that to corporate underwriting, get beyond that to things like mutual funds? Do you draw the line there?

Mr. COLTON. We have not taken a firm position on those items because we do not believe we're experts on it.

Senator RIEGLE. All right. Mr. Googins.

Mr. GOOGINS. Again, we have not dwelt at great length with respect to any individual incremental segment of things that might be added in terms of the securities area other than our fundamental policy. However, with those things that are of great concern to us when it has to do with insurance, we believe that it is not in the best interest of the American public to add insurance powers.

Senator RIEGLE. Well, take a look at the others because I'd like to see if you have a position with respect to the others.

Mr. GOOGINS. We'll have to supplement that for the record.

Senator RIEGLE. All right. Very good. Mr. Flynn.

Mr. FLYNN. The National Association of Realtors is in tandem with NAHB on this particular issue. We've formally gone on record supporting getting it for mortgage-backed securities. Outside of that, we have made no other recommendations. It's beyond our expertise.

Senator RIEGLE. Well, it may be, but I'd ask you also to take a look at that question because we're looking at the whole set of issues. We're not just looking at a single piece of that. So I think we need to have you think that through and give us your view on it.

Mr. FLYNN. We'll be happy to do that.

Senator RIEGLE. Mr. Olson.

Mr. OLSON. In the past as well as now, we would endorse and support all the powers that were contained in S. 790 and obviously, which would be different from the others testifying today, we would also be supportive of additional areas that would be on an agency status on real estate brokerage and insurance.

Most importantly, that they are closely related to banking and that they don't contain further risks to the banking structure.

Senator RIEGLE. Mr. Bailey.

Mr. BAILEY. Mr. Chairman, in deference to Mr. Olson, I would have to say that the only way insurance and real estate is really closely related to banking is that they do extend credit in those areas and it makes it a much more easy opportunity for them to handle this insurance when they are also handling the extension of credit. In that way they are closely related.

I want to reemphasize the fact that banks, in our judgment, should not be permitted to compete with that very commerce that they were created to serve. Banks, if you will, are really just an extension of our monetary system—the banking system. Banks, in my judgment, are a quasi-public utility. They are granted their being by government, either Federal Government or State government, and they have many opportunities that other businessmen do not have. The bank can go to the discount window for funds, and they can go to the FDIC for protection of their depositors.

These are areas of an unlevel playing field that the banks have in their possession, whether we are dealing with securities or insurance powers or real estate.

We are totally opposed to banks being allowed to compete with the commerce that they are supposed to be serving.

Senator RIEGLE. Mr. Chairman, my time is up. Thank you.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you very much.

Let's just go back and sort of continue a little bit what Senator Riegle started.

COMPETITIVE EQUITY

The competitive equity issue is one that's argued.

We're talking about financial instruments to some degree. One of the arguments, of course is that bank expansion into the securities industry should create a two-way street, or real estate should be a two-way street. Are independent agents interested in acquiring banks?

Mr. BAILEY. Not as a group that I know anything about. I am sure there are many independent agents who have interest in banks, as many small businessmen do, whether it is selling cars or selling shoes or whatever they are selling. They are interested in bank ownership sometimes.

Senator DODD. But the competitive equity argument one might apply to the insurance industry or the real estate industry or the securities industry is not, in my view anyway, as applicable when we're talking about independent agents as such. I see a distinction. Do you see a distinction, Mr. Olson, in that at all?

Mr. OLSON. I see the distinction. Again, I come from a small bank who has an insurance agency, so I can speak on both sides. We've offered it. It's the only insurance agency in town. It's a service that's closely related to banking and it's a service that's needed. And this is typical of a lot of communities.

Senator DODD. Those exceptions exist in present law.

Mr. OLSON. That's correct. And with reference to the comment to the real estate business, I really feel that community bankers have as good a feel for the value of real estate, its ability to earn and pay for itself, as oftentimes maybe brokers do. So I think that we do have the expertise in certain cases to provide both of those services to our customer base.

Senator DODD. Let me ask you something, Mr. Flynn. You've just indicated that you would support expanding powers for mortgage-backed securities arguing that it's an asset to home owners and the like.

Why not in the area of real estate, it would seem to me, if you want to assist home owners, reduce brokerage fees and the like? If you argue that allowing banks to get into mortgage-backed securities is going to assist home owners, can't you make the same argument that allowing banks to get into real estate is also going to assist that home owner for the same reasons?

Mr. FLYNN. I would suggest to you that it would not necessarily reduce the cost to the home owners by a rate of commission. Additional people coming into the business—and we have traditionally about 30 or 35 percent of our membership turns over every year, which means those sets of people come into our business, and as I testified verbally when you weren't in the room, even under the circumstances of the best of times in 1978 real estate companies were not necessarily totally profitable. Twenty-five percent of them reported losses in 1978 and we have between 25 and 40 percent that report losses on an annual basis.

So the point of that is that real estate commissions would not necessarily go down if the banking industry or the financial industry would be in the business. That does not necessarily mean the increased competition would reduce the cost. It may mean, however, that the financial institutions would lose additional capital in their subsidiary and need to underwrite that. So we're concerned about that safety of the financial institution.

Senator DODD. Mr. Googins, we welcome you by the way, a Connecticut citizen. We're glad to have you before the committee.

You in your testimony say, talking about the reliability of the holding company to remain separate, you say, "The desire of managers to keep a subsidiary from going belly-up will take precedence over legal constraints of intracompany transfers." You further observe that none of the proposals offer a "realistic solution to this problem."

I wonder if you might comment on whether or not you think there are any possibilities that would alleviate that problem or is the only answer really a total ban on such affiliations? For instance, the narrow bank proposal, does that have any appeal to you at all? Do you see any circumstances in which you could address that basic fundamental underlying problem that you identify in your testimony?

Mr. GOOGINS. There is, of course, a spectrum of things that can be done and, as I mentioned earlier, some noble effort went into prophylactic provisions that would be helpful in some of the bills that we're hearing here today.

But I think, as I mentioned earlier in my oral testimony, the First Options circumstance of Continental demonstrates perhaps that when you're in the heat of battle and you have to make a management decision and you've got a question of whether you let a subsidiary go down, you're going to make the decision and hope things turn out for the best later. It may or may not turn out for the best later.

That suggests that maybe the best firewall is to have a clean separation of the banking and commerce powers in the first instance.

Senator DODD. So you see no other vehicle available that would create that kind of firewall for including the narrow bank approach?

Mr. GOOGINS. I think we would prefer a total separation. We really have serious questions as to whether or not the firewalls are adequate.

Senator DODD. Some insurance companies, like the Travelers Insurance Co., have a nonbank bank.

Mr. GOOGINS. Yes, indeed, Senator, and I think that there are probably a dozen or more companies in our association that have such institutions. But I daresay—and some of them announced publicly—that in the event that they had to give up those institutions to go back to what they believe was the appropriate separation of banking and commerce, a significant majority of them would do just that.

Senator DODD. Do you think the Travelers would?

Mr. GOOGINS. I do not know. I cannot speak for the Travelers or any other individual company. But they are a reputable company, Senator, as you know. [Laughter.]

Senator DODD. You have no argument on that point. I'll get back to you, Mr. Colton. Thank you.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you very much, Mr. Chairman.

CONCENTRATION OF ECONOMIC POWER

Gentlemen, I would ask if any of you would comment on the age-old argument that if you combine banking with other financial industries such as securities or real estate or insurance you would have a concentration of economic power developing in the economy. I think we would all agree that there is a potential for tie-ins when banks enter some of these other industries.

I'm concerned about a concentration of economic power if we take down barriers and let the banking industry move into areas where they are presently prohibited from going.

Is this a concern of anyone on this panel?

Mr. GOOGINS. Senator, it is indeed a concern to our institution. If you took the assets of the top 10 bank holding companies in this country, they exceed the total assets of all 2,000 life insurance companies.

And I believe, if the giant institutions or even currently smaller institutions were allowed to pierce the current veil between banking and commerce, you would find a very, very significant and rapid accumulation of other enterprises that would indeed produce the very concentration that you're concerned about.

Mr. **Colton**. Senator, as I said before, I think we feel that the world is changing so we have to adapt to the changing world, but we certainly share that concern when we talk about real estate development.

I think there is no question that if in fact you opened the door broadly to banks to be involved in development activity, they would clearly be at a competitive advantage. Banks would have all of the funds for a project and would be in a position where if a builder or a developer were applying for a project finding banks would have the leverage to completely control the funding decisions. I think that could be dangerous in terms of safety and soundness and economic concentration of power in those institutions in that area. So we do have that concern.

Senator **Sasser**. Mr. Flynn.

Mr. **Flynn**. Two points we have. One that I think gives rise to the unfair competition that we articulated in the written testimony giving specific examples of where institutions are in the business of real estate that have taken advantage unfairly.

Second, let me make a comment about developers. Left unfettered, I think they would build us to oblivion. Being one myself, I know that I have that penchant, as do many of my fellow developers. And that if you don't have some offsetting conservative point of view—that is the capital markets that ask you to cut the cards 5, 10, 15 times, because they're not profiting as you profit by taking the risks, then I think you have the right kind of joint venture and the equation is balanced on each side.

The major concern I'd have is the subsidiaries of these institutions now would profit or they would pretend to profit from that, that they would be unfettered in fact and build us to oblivion and not only risk the integrity of the financial institution, but the integrity of the buildings and the properties that are already there because there would be way too many for us to absorb in the marketplace.

Senator **Sasser**. Well, let me sharpen this question up and address it really to Mr. Olson and Mr. Bailey and also to you, Mr. Flynn.

If we repeal Glass-Steagall—Mr. Bailey and I call it Glass-Steagaul, but most folks around here call it Glass-Steagall [pronouncing the term]—if we were to repeal Glass-Steagall, and looking down the road 5 years after repeal, where would your industries be? What type of environment would we be operating in with regard to insurance, with regard to real estate, with regard to independent banks?

Mr. **Olson**. The repeal of Glass-Steagall would result in probably fewer financial institutions, of which I think that there will be anyway in the future, fewer financial institutions down the road. Again, obviously, much more concentration. I again think about it from a community bank standpoint of our ability then to serve the needs of our consumers out there with fewer financial investors. And I look at the deposit-taking structures and trying to have a feel for that. Is it likely that deposits might leave areas and travel to where they would be used to a great extent or where the need was greater at a higher rate and maybe not effectively be available for the use of development of industry and so on in less developed States and areas across the middle section of the country.

Mr. BAILEY. Senator, I appreciate your comment there, how we pronounce Steagall. I know that you are from Tennessee, and I suspect you also know my good friend, Johnny Hayes——

Senator SASSER. I do, indeed.

Mr. BAILEY [continuing]. Who is a member of our Government Affairs Committee, a very delightful gentleman. I was rather startled recently when it came to my attention that the assets of Citicorp are greater than the assets of all of the banks in the State of Texas, and then I discovered that the assets of Citicorp and Bank of America combined are greater than the assets of all the banks in Texas, New Mexico, Oklahoma, Arkansas, and Louisiana. These are rather staggering figures. As a matter of fact, I am quite certain that the assets of that corporation are greater than many governments of the world. The concentration of power, economic power becomes a very viable question.

I regularly receive, and I am sure practically everyone in this room today receives offers of credit cards and other services from these major bank holding companies, Citicorp, specifically, and I am not picking on them—many of the other banks are included. But you ask, if they are given the powers to sell insurance, for example, they will start selling those products, annuity contracts. If Glass-Steagall is repealed, they can sell annuity contracts through the mail, in many ways, whether they have tremendous abilities through the asset concentration of that institution to offer these products to the American public, products offered where there is no agent involved, where a person is not available to advise them whether the contract is good, bad or indifferent.

And I think it is a dangerous thing for the consumer and would have the effect of creating tremendous concentration of power of assets in those companies.

Senator SASSER. Anybody else want to respond to that?

[No response.]

My time is up, Mr. Chairman. Thank you.

The CHAIRMAN. Well, thank you very much, gentlemen.

Senator Riegle, if you have any more questions, we can go ahead, but we have two more panels.

Thank you very, very much for excellent testimony. It is most helpful.

Mr. BAILEY. Thank you.

The CHAIRMAN. All right. The next witness is James Morton, chairman and chief executive officer of the John Hancock Mutual Life Insurance Co. of Boston, testifying on behalf of the Financial Services Council.

Mr. Morton, we are delighted to have you. I understand you have several others who will accompany you——

Mr. MORTON. Yes, I do.

The CHAIRMAN. Mr. Bogaard, who is executive vice president and general counsel of First Interstate, Mr. Fitzpatrick, who is executive vice president, general counsel and secretary of CalFed, and Harry Freeman, executive vice president of American Express.

Gentlemen, welcome. We are happy to have you here.

Go right ahead, sir.

STATEMENT OF E. JAMES MORTON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., BOSTON, MA, ACCOMPANIED BY WILLIAM J. BOGAARD, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, FIRST INTERSTATE BANCORP; WILLIAM J. FITZPATRICK, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, CALFED INC.; AND HARRY L. FREEMAN, EXECUTIVE VICE PRESIDENT, AMERICAN EXPRESS CO., ON BEHALF OF THE FINANCIAL SERVICES COUNCIL

Mr. MORTON. Mr. Chairman, I am going to make a statement on behalf of the Financial Services Council.

Perhaps, at the beginning, I might save a little time at the end if you are going to ask that same question about our group. Our measure of opposition to S. 1905 is zero. And I think if I had to determine an average for the other two bills, they'd both be five. But we are a very diverse group, and I would remind you that it is possible to drown in a river whose average depth is 6 inches.

The CHAIRMAN. When you say zero for S. 1905, that means that you have no opposition to it; is that right?

Mr. MORTON. That's right.

The CHAIRMAN. And you are opposed to the other two, and between 0 and 10, you make it 5. OK.

Mr. MORTON. That's an average; right.

My name is E. James Morton. I am chairman and chief executive officer of the John Hancock Life Mutual Life Insurance Co., and I am appearing here today on behalf of the Financial Services Council, and in that connection, I am accompanied by those representatives whom you just introduced.

Our membership represents a very broad cross section of the financial services industry, including banking, thrift, insurance, securities, finance company and diversified firms. A list of our Council's membership is attached, I believe, to our oral testimony.

SUPPORT FOR S. 1905

We strongly support S. 1905, the Depository Institution Affiliation Act which was introduced by Senators Cranston and D'Amato, because it affords all providers of financial services an equal opportunity to compete and to meet the needs of their customers. At the same time, we strongly oppose any extension of the moratoria contained in titles I and II of CEBA.

We believe that you, Mr. Chairman, and Senator Garn are to be commended for focusing attention on the need for reform of the Glass-Steagall Act in S. 1886, the Financial Modernization Act of 1987. And we also think that Senators Wirth and Graham are to be commended for introducing S. 1891, the Financial Services Oversight Act which seeks to develop a new regulatory structure for financial services.

We have reviewed those proposals and S. 1905, and we think it is significant that all three of those proposals have a lot of elements in common, and they reflect agreement on a number of basic principles and objectives.

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December 21, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and Urban Affairs
U.S. Senate
534 Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the NATIONAL ASSOCIATION OF REALTORS®, I am pleased to submit the following information, for the record, in response to questions that were posed to Norman D. Flynn during the December 9, 1987 hearings of the Senate Committee on Banking, Housing and Urban Affairs on the restructuring of the financial services industry.

Senator Riegle asked the following questions:

> "What do you think ought to be done about [the] Glass-Steagall [Act] at this point?...What expanded powers do you think ought to be granted at this point?"

The NATIONAL ASSOCIATION OF REALTORS® does not have a policy specifically addressing whether, or how, the Glass-Steagall Act should be altered. However, the Association strongly supports the intent of the Glass-Steagall Act to separate banking and commerce activities and assure the safety and soundness of the financial system. It should be clear, however, that the Glass-Steagall Act is not the only legislation that the Committee needs to address. From the real estate perspective, it is amendments to, and interpretations of subsequent legislation, established on the sound foundation of the Glass-Steagall act (such as the Bank Holding Company Act) that will determine whether financial institutions will be permitted to engage in such real estate activities as brokerage, management, and/or development. We respectfully urge the Committee to conduct its comprehensive review of the restructuring of the financial services industry by examining the full range of legislation that governs the industry.

The NATIONAL ASSOCIATION OF REALTORS® neither supports nor opposes the repeal of the Glass-Steagall Act. However, we do believe that since its enactment, the Glass-Steagall Act has performed well to protect the financial system. As Congress amends or repeals the Act, and any subsequent acts, we believe it necessary and appropriate to pursue the following goals:

Maintain the Public Trust - We are wary of unnecessarily changing a financial system which has long met its fiduciary responsibility to the public. The Federal charters of these institutions have been written in a manner so as to promote public confidence in this system. There is a grave risk that changes in the permitted activities of these financial institutions would harm their traditional deposit-taking and credit-granting functions and disrupt the payment system on which our economy relies.

Promote the Safety and Soundness of Financial Institutions - We are concerned that a precipitous restructuring of the financial services industry will materially harm the safety and soundness of the financial system. In particular, we are concerned that individual institutions would be allowed to incur unnecessary risk, and that the failure or losses of these institutions would undermine the viability of the entire financial system. The availability and accessibility of mortgage funds is dependent upon a strong, vibrant financial structure and should not be jeopardized by ill-considered deregulation. We strongly question whether real estate activities are appropriate business activities for financial institutions.

Prohibit Unfair Competition - We are concerned as to how authorizing financial institutions to engage in real estate activities will affect the practical business operations of the existing real estate industry. Additionally, we are concerned with how changes to the Glass-Steagall Act may affect subsequently established legislation involving whether and/or how engaging in real estate activities should be permitted for financial institutions.

In response to the question of what additional powers should be awarded to financial institutions, the NATIONAL ASSOCIATION OF REALTORS® supports the awarding of mortgage-backed securities. The NATIONAL ASSOCIATION OF REALTORS® distinguishes between mortgage-backed securities and all other securities. Mortgage-backed securities have proved, during the late 1970's and early 1980's to be a sound instrument for the issuer. While there is some additional risk associated with these instruments, mortgage-backed securities should provide financial institutions with a higher return at a relatively low cost. Moreover, the benefits to be derived from increased competition far outweighs this risk. The NATIONAL ASSOCIATION OF REALTORS® has no policy addressing other specific powers that should be awarded to financial institutions.

Thank you, once again, Mr. Chairman, for the opportunity to contribute to the Committee's examination of the restructuring of the financial services industry. As always, please let us know if we may provide the Committee with any additional information.

Sincerely,

Stephen D. Driesler
Senior Vice President

cc: The Honorable Donald W. Riegle

The scope of those proposals further demonstrates that the nature of the debate on this subject has changed, due largely to the work done by Congress and the administration and the FDIC and other financial regulators, the academic community and perhaps not least the financial services industry itself. The issue, we believe, is no longer whether there should be change, but how comprehensive that change should be.

Guided by the principles which you will find in my written statement, the Council set out with the purpose of crafting an even-handed legislative proposal.

Despite the diversity of our membership, we were able to agree on a comprehensive legislative framework that breaks the competitive gridlock by providing broad reciprocal market access, while simultaneously enhancing the efficiency and the safety and soundness of all financial institutions.

Subsequently, Senators Cranston and D'Amato and their staffs made some significant improvements to our original proposal.

S. 1905 would allow any financial or nonfinancial business to be affiliated with a federally insured bank or thrift, provided that the company became what the act we calls a depository institution holding company and complied with the act's regulatory and supervisory provisions. A bank or a thrift subsidiary of such a company would be subject to the existing bank supervisory and regulatory standards and to certain additional restrictions which are designed to insulate the depository institution from its noninsured affiliates.

In this regard, it should be emphasized that S. 1905 establishes very important safeguards to enhance safety and soundness, and those safeguards also are more fully set forth in my written statement.

The Council believes that these restrictions effectively protect a bank or a thrift subsidiary from risks in any activities conducted by the depository institution, holding company or its other affiliates. The Council does, however, have some technical suggestions with respect to certain of the provisions, especially the restrictions on transactions with securities affiliates, which we will submit in writing for the committee's consideration.

Overall, what makes S. 1905 workable is its reliance on the principle of functional regulation. Second, S. 1905 takes what we believe is a properly balanced approach to the relationship between State and Federal regulation. Third, S. 1905 recognizes the need for improved coordination among the various Federal and State financial regulators and establishes such a mechanism through the National Financial Services Committee.

Finally, in order to bring much needed capital into the thrift industry, and thereby further improve the situation of the Federal Savings and Loan Insurance Corporation, title III of S. 1905, increases the value of the thrift charter by removing certain onerous restrictions on thrift institutions and their parent savings and loan holding companies.

The benefits of S. 1905's comprehensive approach are clear. Whenever artificial market barriers are removed, customers pay less for products and services. They receive a better value and they have a wider choice of products and services. Prices more closely parallel actual costs and the incidence of cross subsidies declines.

To remain competitive, providers become more efficient and more cost-conscious.

S. 1905 brings these attributes of increased competition to the entire financial services industry. As the committee has heard in the course of its extensive hearings over the past several years, revolutionary changes have occurred in the financial services marketplace. The securitization of assets, erosion of market barriers at home and removal of barriers abroad, the institutionalization of savings, as well as product innovations fostered by technological advancement are but a few of the fundamental forces reshaping the marketplace.

Today, no one disputes the premise that financial markets are necessarily global and irretrievably linked together. Against that background, any initiative which appeals only to domestic parochial considerations, places this country at a significant competitive disadvantage and leaves our financial services industry vulnerable.

In sum, the financial services industry has changed, but regulation has not. As a result, customers are being short-changed, America is falling behind, and time is running out. Congress can and should conform yesterday's regulation to today's marketplace. The economic inefficiencies and unnecessary costs are well-documented. The competitive imbalance between providers is beyond dispute.

The bill, which affords all an equal opportunity to compete and to meet the needs of their customers, S. 1905, is now before you. We pledge our cooperation to work with the committee to achieve meaningful reform in this Congress.

That is the end of my formal statement.

[The complete prepared statement of Mr. Morton follows:]

STATEMENT BY E. JAMES MORTON

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY

Mr. Chairman and Members of the Committee:

My name is E. James Morton and I am Chairman and Chief Executive Officer of John Hancock Mutual Life Insurance Company. I am appearing here today on behalf of the Financial Services Council ("Council").

The Council strongly supports S. 1905, "The Depository Institution Affiliation Act," introduced by Senators Cranston and D'Amato, because it affords all providers of financial services an equal opportunity to compete and meet the needs of their customers. At the same time, the Council strongly opposes any extension of the moratoria contained in Titles I and II of the Competitive Equality Banking Act of 1987.

We believe the Chairman and Senator Garn are to be commended for focusing attention on the need for reform of the Glass-Steagall Act in S. 1886, the Financial Modernization Act of 1987. Senators Wirth and Graham are also to be commended for introducing S. 1891, the Financial Services

Oversight Act, which seeks to develop a new regulatory structure for financial services. Having reviewed these proposals and S. 1905, we believe it is significant that all three proposals have many elements in common and reflect agreement on a number of basic principles and objectives.

Each proposal recognizes that there have been profound changes in our financial markets and that restructuring must occur now if we are to continue to benefit from a strong and sound financial services industry. Each proposal recognizes that restrictions on affiliations with depository institutions need to be liberalized and that we need to move toward a system of functional regulation. Both S. 1905 and S. 1886 recognize that effective firewalls can be built between an insured depository institution and its affiliates and each provides additional regulatory and supervisory tools to assure safety and soundness. Both S. 1905 and S. 1891 also recognize that greater coordination is needed among the financial regulatory agencies in an increasingly interdependent regulatory and business environment -- a point graphically underscored by the events of October 19th.

The scope of these proposals further demonstrates that the nature of the debate has changed, due largely to the work done by members of Congress, the Administration, the FDIC, other financial regulators, the academic community and the financial services industry. The issue is no longer whether there should be change, but how comprehensive that change should be.

The Council's Guiding Principles

The Council's membership includes companies from all segments of the financial services industry, as well as diversified firms which engage in both financial and non-financial activities. The Council is guided by the following general principles:

-- Current laws and regulations governing financial services are inefficient and obsolete, and prevent consumers, businesses and local governments from obtaining better and more competitively priced financial services.

-- Financial services legislation should be comprehensive and procompetitive. Existing laws that restrict competition should be modernized. A new legal framework for financial services should be created which will afford all financial services companies equal opportunity to serve the full range of credit and financial needs in the marketplace.

-- Expanded product and service opportunities for all components of the financial services industry would strengthen individual intermediaries as well as the overall financial system.

-- Rapid globalization of the financial services marketplace and the emerging interdependence of major financial markets further underscore the necessity of modernizing domestic laws to maintain the competitiveness of U.S. intermediaries and the preeminence of U.S. financial markets.

-- Regulation of separate segments, subsidiaries and affiliates along functional business, product and service lines without regard to ownership and control would serve national priorities better than the present system. Functional regulation would foster diversification by financial intermediaries, promote fair competition and assure equality of regulation. Holding company supervision should be minimal, residual in nature, and then related only to specific goals of public policy.

The Development of the Council's Legislative Proposal

Guided by these principles, the Council set out to craft a legislative proposal. Representatives from banking, insurance, thrift, securities, finance company and diversified firms participated in this process. Though many predicted that such a diverse group could not agree on a proposal, the skeptics were wrong. Despite their diversity, our members were able to agree on a comprehensive, legislative framework that breaks the competitive gridlock by providing broad reciprocal market access, while simultaneously enhancing the efficiency and safety and soundness of all financial institutions.

Our members recognized at the outset that if consumers, businesses and local governments were to receive the benefits of free competition in the provision of financial services, the complex and frequently conflicting body of laws regulating banking, insurance, securities and other financial services had to be reconciled in a manner consistent with safe and sound practices. Obviously, the task of resolving the conflicts among these various laws required that some of these laws be modified.

In developing the proposal, members researched and discussed a wide range of issues, including how insured depository institutions could be insulated from the activities of non-insured affiliates, whether ownership restrictions on depository institutions should be repealed, whether a new alternative regulatory structure should be created, how supervisory and enforcement powers could be strengthened, how functional regulation could be implemented in an effective and workable manner, how there could be more effective coordination among regulatory authorities, and the extent to which State laws had to be preempted.

All of these considerations were coordinated and resolved in developing a legislative framework. Subsequently, Senators Cranston and D'Amato and their staffs made significant improvements to the Council's proposal. S. 1905 is now a balanced proposal that accomplishes the goals outlined above.

The Principal Elements of S. 1905

S. 1905 would allow any financial or non-financial business to be affiliated with a federally-insured bank or thrift, provided that the company became a Depository Institution Holding Company ("DIHC") and complied with the Act's regulatory and supervisory provisions. A company which became a DIHC would be exempt from the ownership and activity restrictions of the Bank Holding Company Act ("BHC Act"), Glass-Steagall Act, or Savings and Loan Holding Company Act ("SLHC Act"). However, such a company would be subject to existing bank supervisory and regulatory standards, and to certain additional restrictions designed to insulate the depository institution from its non-insured affiliates. The DIHC structure would be entirely optional and would not be required for any company that wished to continue functioning under its current regulatory scheme and existing legal restrictions.

Among the safeguards of existing law specifically applied to DIHCs and their depository institution affiliates under S. 1905 are:

-- The prior notification requirements of the Change-in-Bank Control Act and Change-in-Savings-and-Loan Control Act;

-- The affiliate transaction prohibitions and restrictions of Sections 23A and 23B of the Federal Reserve Act;

-- The interstate banking restrictions of the McFadden Act, the BHC Act and the SLHC Act;

-- The anti-tying prohibitions of the Bank Holding Company Act Amendments of 1970;

-- The insider lending prohibitions of section 22(h) of the Federal Reserve Act; and

-- The requirements of the Community Reinvestment Act.

An insured depository institution affiliate of a DIHC would also be subject to the same supervisory, regulatory, examination and enforcement provisions imposed on any other insured depository institution and its customers would benefit from the same panoply of consumer protection measures, including truth-in-lending, electronic funds transfer and expedited funds availability laws and regulations.

In addition S. 1905 establishes important additional safeguards to enhance safety and soundness:

-- The regulatory agencies are authorized to promulgate regulations to ensure that bank or thrift subsidiaries of DIHCs do not engage in unsafe or unsound practices with affiliates;

-- Bank or thrift subsidiaries of DIHCs are subject to stringent prohibitions and restrictions on their transactions with any securities affiliate of a DIHC;

-- The regulatory agencies are authorized to cause bank or thrift subsidiaries of DIHCs to maintain additional capital in an amount of up to three percent of the bank or thrift's total assets;

-- If a bank and thrift subsidiary of a DIHC falls below minimum capital requirements, the DIHC is required to either restore the subsidiary's capital within 30 days or divest it within 180 days;

-- Regulatory agencies are authorized to go immediately to court to enjoin actual or prospective violations of the Act;

-- Regulatory agencies are authorized to require a DIHC to promptly divest its subsidiary bank or thrift if the DIHC engages in a course of conduct which threatens the safety and soundness of the affiliated bank or thrift;

-- In no instance can the benefits of federal deposit insurance coverage applicable to a bank or thrift be extended to a DIHC or to any of its non-insured affiliates;

-- Regulatory agencies are authorized to examine the books and records of and require reports from any affiliate of a bank or thrift controlled by a DIHC; and,

-- Severe, strengthened criminal and civil penalties, including civil money penalties directed at individuals as well as businesses, are imposed for willful violations of the Act or any of its implementing regulations.

The Council has carefully reviewed the restrictions in S. 1905 and believes they protect a bank or thrift subsidiary of a DIHC from risks in any activities conducted by the DIHC or its other affiliates. The Council does, however, have some technical suggestions with respect to certain of the provisions, especially the restrictions on transactions with securities affiliates, which we would like to submit in writing for the Committee's consideration.

Overall, what makes S. 1905 workable is its reliance on the principle of functional regulation. We believe regulation is most effectively conducted by the primary regulator of a bank or thrift and thus support giving bank and thrift regulators more tools and resources to do their jobs. Similarly, regulation of an insurance company, securities or other affiliate of a DIHC is most effectively conducted by the primary regulator of such affiliate, whether it be the State Insurance Commissioner or the Securities and Exchange Commission.

In addition, S. 1905 takes a properly balanced approach to the relationship between State and Federal regulation. Companies that do not elect to become DIHCs would be free to continue operating under the present regulatory system and would thus be able to avail themselves of further modifications of State law. The States' role as laboratories for change is thus preserved.

Companies that elect to become DIHCs and their affiliates would remain fully subject to State regulation, except that State laws imposing ownership or activity restrictions analogous to those in the BHC Act, SLHC Act or Glass-Steagall Act would be preempted. In addition, no bank or thrift subsidiary of a DIHC would be able to directly engage in securities, insurance or real estate activities. DIHCs that were bank holding companies or not previously engaged in insurance agency or real estate brokerage activities would be required to acquire existing concerns as a condition of entry into those markets.

Recognizing the need for improved coordination among the various Federal and State financial regulators, S. 1905 establishes such a mechanism through the National Financial Services Committee. As part of its responsibilities, the Committee is directed to study and recommend any further measures that may be needed to ensure that regulatory agencies are appropriately staffed and to ensure that the federal deposit insurance funds are protected.

Finally, in order to bring much needed capital into the thrift industry and thereby further improve the situation

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of the FSLIC, Title III of S. 1905 increases the value of the thrift charter by removing certain onerous restrictions on thrift institutions and their parent savings and loan holding companies. Many of these proposals have previously been presented to the Committee and thus we will not address them in detail here. However, we believe Title III constitutes an important part of S. 1905 and it is strongly supported by the Council.

Public Benefits of S. 1905

As is the case whenever artificial market barriers are removed, customers pay less for products and services, receive a better value, and have a wider choice of products and services. Prices more closely parallel actual costs and the incidence of cross subsidies decline. To remain competitive, providers become more efficient and cost conscious. S. 1905 brings these attributes of increased competition to the entire financial services industry.

Moreover, S. 1905 opens up new sources of capital and management expertise. By facilitating broader diversification, S. 1905 prevents undue reliance on any one line of business. By enhancing the thrift charter, more capital may be attracted to that troubled industry. By removing impedi-

The CHAIRMAN. Thank you very, very much, Mr. Morton, for a clear statement.

Let me ask you this. You are certainly experts on much of what we have before us, but perhaps you are not as expert as some of us are, at least, as to what we can get through Congress and what we cannot.

Supposing the only alternative, the only practical political alternative were to pass S. 1886, that's Proxmire-Garn, or nothing. Which would you take?

Mr. MORTON. Well, I believe that what you see here is a collection of diverse organizations besides insurance companies. We have banks, we have securities firms and so forth. And I think that if the political considerations were such that only one thing could be done, you would have a variety of individual responses to that thinking.

It seems to me that the bill that Senator Garn and I are introducing has the best chance of passing. And if, in our judgment it is the one thing we have any chance of getting through in the coming year, would you take it?

Mr. MORTON. I think that what would happen is that some members of the Financial Services Council would oppose that bill, and you would hear from individual members of the Council as to whether they did or whether they didn't.

I think that if it were presented, as I have heard today, as the first step in a program which was ultimately designed to lead to comprehensive reform, it would be a lot easier for some members to take. However, there is a fear is that instead of a first step, it might end up being a last step, and people would believe that they had solved this whole problem of the expansion or the nonexpansion of bank powers by dealing with the Glass-Steagall problem, and could thus go away for a few years without doing the right thing by enacting comprehensive reform.

So in brief, I think that some members of the Financial Services Council oppose the Proxmire-Garn bill in its present form, because they think a more comprehensive proposal is needed.

The CHAIRMAN. Let me ask you a question about the Black Monday. In testimony yesterday, the Securities Industry Association claimed that in light of the crash, Congress should move more slowly on any kind of Glass-Steagall modification. We should wait until we have seen the autopsy report.

Would you agree with that? Including to move more slowly on S. 1905?

Mr. MORTON. Well, I think, my personal opinion, Senator, is that Congress has been moving very slowly. I agree with Senator Garn's opinion on that, and I think that more and more movement is needed and needed quickly.

If I may take this opportunity to——

The CHAIRMAN. I am not sure I understood. You said we should act more quickly?

Mr. MORTON. Yes.

The CHAIRMAN. I certainly agree with that.

Mr. MORTON. Yes. And by the way, to clarify the Council's position as a body, the official position of the Financial Services Council on S. 1886 is neutral. [Laughter.]

The **Chairman**. Well, that is a great improvement. [Laughter.]

That's very good. I am going to have to leave shortly to go to the floor. I hope I can get back before we are through today. We have another panel after you. But Senator Garn, go ahead.

Senator **Garn**. Thank you, Mr. Chairman. I might say before I address this group, I had to leave to go to another meeting, before the other panel left, and I think most of you are here to hear what I said to them.

Senator Gramm said that if they don't look out for their own self-interests, then who would? And I agree with that. My problem is when the positions are so inflexible. As an example, with the insurance agents, they are not even included in this bill, we deliberately left them out, but they are still here griping. Even when they are not affected by the repeal of the sections of Glass-Steagall, they are going to be here as a preemptive strike; just in case—[laughter]—something happens. So there is a difference between protecting your own self-interest and blindly stating a position year after year after year with no flexibility whatsoever. So I don't disagree with Senator Gramm and tell people that they shouldn't be here.

That leads me into complimenting you gentlemen, whatever your positions are, simply because I am a little bit amazed that such a diverse group of companies can get together, because you also have self-interests which you need to protect, but it is the type of thing I have hoped for years, that people would—while protecting their own self-interest, would be willing to give enough to try and come together, not liking the whole product, but enough that they would go ahead.

Whether I agree with you or not on the specifics, my point is that I am pleased that a group of diverse companies with self-interests of their own, are willing to get together, regardless of the outcome of that product or whether I agree with it or not. And until that happens with a lot of other groups, there won't be any legislation, and I don't have to be much of a prophet to predict that, after all these years of seeing it come to what we thought was close to a bill, another step in the process and then see it defeated by one group or another.

But I want to get back a little bit to what Chairman Proxmire was talking about. I think most of you are well aware that I prefer a broader approach than Proxmire-Garn I always have, and I certainly do now, but in light of what has gone on at least the last decade, once again the chairman is absolutely correct. He doesn't have to be a visionary to predict that swallowing the whole apple all at once, if not difficult, is virtually impossible, unless suddenly there is a great change in the House of Representatives. We have always been able to do things in the Senate that the House was not willing to do. My last bill in 1984, 89 to 5 in the Senate, rather a convincing margin with new powers and so on. The House wouldn't even go to conference with it.

SHOULD IT BE ALL OR NOTHING?

So I want to renew the question Senator Proxmire asked in light of evidence, not opinion, of how difficult it is to get even incremental or step-by-step approaches through here. Even though you said you are neutral, do you really want nothing, the status quo, if you can't get the whole thing, and if so, why?

Mr. **Freeman**. Senator Garn, could I respond, at least for my company?

Senator **Garn**. Sure.

Mr. **Freeman**. I think our view is very simple. I have been 13 years responsible for the area of government relations, whether in Washington or around the world.

Senator **Garn**. You've got more hair left than I have.

Mr. **Freeman**. I'm gaining on you, though. [Laughter.]

But I've gone through these years of frustration with you, and we have come to the conclusion that we too are very tired of the piecemeal approach of spending a lot of time, money and emotion on such esoteric issues as nonbank banks and whether banks should have mortgage-backed securities powers, and so forth. We decided that piecemeal efforts world never work and decided to build a broad coalition for reform. We are now really amazed and pleased that we could get the kind of diverse 17 companies from all over the industry to sit down and agree and go for the whole thing.

Our view is that anything short of something like S. 1905 doesn't do the job. What has happened in the marketplace and allowed by Congress is that you've created, gone from the separate eggs, where separation was there in the 1930's to a big omelet. If you act along the lines of anything short of what we are talking about in S. 1905 or something very similar to it, you just make a bigger omelet. And the very basic concern that we have with every other financial institution, whether big or small, whatever kind, is safety and soundness. The more complex and the bigger that omelet, the more concern everybody should have—you, our companies, the public—about safety and soundness.

The crash, the financial crash in October, was a scary event that I saw, I lived through in my office for a couple of days. We don't want to see that happen. We got through it pretty well, but I can assure you this piecemeal approach is a bad way to do it. We have got to improve the quality of regulation. I think S. 1905 where you provide separate subsidiaries, for banking and depository institutions and investment securities under a framework of functional regulations and give the regulators the power that they can get information following a transaction from all of these places is going to improve the quality of regulation. You can get information from the other regulators on an instant basis. That goes to the heart of the problem. High quality regulation. And that is why we say, we don't want the piecemeal approach. We prefer to have nothing. Let's keep the omelet the same size, but let's not stop there. Let's go to what S. 1905 stands for, a real financial services industrywide approach. Let's do it.

Senator **Garn**. Mr. Freeman, substantively, I agree with you, but after sitting in this position for 13 years, to end up with nothing—I can't agree with you to endorse an all or nothing approach from a political or a process standpoint here in the Senate. Substantively, I agree, and I think you know that. I have vented my frustration for years over the piecemeal approach, but I am pleased that 17 of you can get together. I think it is a step forward. I compliment you for that, but we do disagree on an all or nothing approach.

Thank you.

Senator **Riegle** [presiding]. Well, it strikes me that there are differences of opinion within the group on that issue. Mr. Morton, you ventured a notion that perhaps the group would not favor the Proxmire-Garn position, and that may or may not be your own personal view, but then apparently the official view of the organization is neutral, but Mr. Freeman, I think, makes it clear that he feels that he would be on the other side of that, that we ought not to go that route, if we are not going to have a rather sweeping set of changes here.

So I think there clearly are differences of points of view, and that is not surprising, because everybody is configured differently, and these are hard areas to agree on. So I don't say that to emphasize the differences of opinion, but only to say that it is apparent that there are some, and that is not, in my view, terribly surprising

I would like to have each of you state for the record, what you think the risks or the consequences are to our economic future or our financial services industry economic future, if proposals like the ones that you were making are not adopted. If time just runs and the status quo is maintained without legislative change, apart from the impact from your individual companies, what are the risks to the country or to our competitive standing or to our financial services industries, as you would see them from your respective vantage points?

Mr. **Bogaard**. Thank you, Senator Riegle. May I say first, if time allows, I would like an opportunity to address the previous question a moment before this panel's done.

Senator **Riegle**. I think you should have the chance to do that. Why don't you do that first?

Mr. **Bogaard**. OK. I would be glad to. I would express thanks to Senator Garn for his recognition of the achievement that this panel represents, the work of the Financial Services Council. I think it represents a direct response to the suggestion that has come from you, sir, and from you, Senator Garn, and from others, that the providers of financial services should come together and reach agreement as to what the future of the legal system for financial services in this country ought to be.

As a member of the Financial Services Council, I and the other banks that are members of the Council support S. 1905. It represents a comprehensive legislative response to the rapidly changing marketplace, to increasing globalization and to securitization of the financial markets throughout the world. We don't, however, I and the other banks who are members of the Council, believe it is essential to allow all of the affiliations that are contemplated by S. 1905 to occur before permitting some of them to occur. We believe S. 1905, I guess, you also, Senator Garn, believe this, represents the best public policy that could be achieved, or at least the right direction. We also, however, recognize the politics involved. So I would say we believe, I and the other banks, that S. 1905 is the best public policy and may be a good politics. We are encouraged by the extent to which debate is under way, not only on the Proxmire-Garn bill but other more far-reaching pieces of legislation.

As to S. 1886, we believe it represents good public policy and perhaps excellent politics.

RISKS TO ECONOMIC FUTURE

With respect to the other question, Senator Riegle, from my perspective, I would say that the risks that we run by not proceeding with a meaningful restructuring of the financial services industry can be described as threefold. One is that the consumers of this country will miss out on the opportunity to get lower prices and better value and greater access to financial services in the United States.

Second, the banking industry will continue to falter in relation to other financial services industries, because there is not a level playing field that permits all financial service providers to provide a full range of financial services.

And third, it seems to me that the financial services industry of this country will continue to erode its stature on the global scene, because of the very strong performance by financial institutions in Japan and in England and in Germany and in other countries of the world.

Mr. **MORTON**. I agree with the response to your question. I would also add that I think that if something like S. 1905 does not pass that allows equal access by nonfinancial as well as financial institutions to the financial services market, then the current need for capital which is being felt across the financial services industry will intensify.

Mr. **FITZPATRICK**. Senator, first, we would associate ourselves also with the remarks you heard earlier in response to Senator Garn's question, that if the issue were a straight up and down, no other choice vote, status quo or S. 1886, we think S. 1886 is a step forward, but we hope that it would be part of a process, but if that was the only choice, we would support it.

In response to your question, we have a particular interest in the future strength of the two insurance funds, FDIC, FSLIC. We think it is essential that steps be taken to strengthen the industry, so that those funds, in turn, will be strengthened.

One of the virtues of S. 1905 is that it permit additional capital to enter the industry, particularly the thrift industry, and second, provides those companies that are already in the industry with other opportunities to strengthen themselves internally.

Absent some attempt to rationalize the system, it is our feeling that any time regulatory or legislative rules conflict with what's actually happening in the marketplace, dislocations occur. They have certainly occurred in our industry, and we have suffered as a result. And we think a comprehensive approach is really essential to maintaining the strength of those two funds and maintaining the strength of our industry.

Mr. **FREEMAN**. To answer you, Senator Riegle, perhaps two categories. First, the foreign competition point. With Big Bang in the United Kingdom, the British banks have become universal. On the Continent, as well as the United Kingdom, the Common Market is shooting for 1992 for a harmonization and many—that would mean that financial institutions of all kinds in the Common Market in Europe will come together, will be able to compete. They will grow, they will become more powerful. The sounds we hear out of Brussels, frankly, is European for the Europeans, kick out the Americans.

Canada has had its Little Bang version. Japan announced through the Ministry of Finance the other day the first step to universal banking and financial services.

So I think that if nothing happens, and I don't know what year it will be, I think the foreign interests who are already starting to eat our lunch will get to the dessert.

Second, on the subject I mentioned earlier, I think having lived through Black Monday and the night after Black Monday and the day after, Tuesday and Tuesday night, doing nothing or something short of S. 1905 will continue to erode the quality of safety and soundness regulations throughout the whole financial services industry.

And nonaction on a comprehensive bill will erode that to the point of more and more risks. We hope we don't have another Black Monday, but if we do, then I would be very, very seriously concerned by lack of action by the Congress to shift to something like we are talking about and getting away from this piecemeal approach which really erodes the safety and soundness principle.

Senator **Riegle**. If I may, Senator D'Amato, it's your turn, if you would indulge me, I would like to just pursue that last point one more step, and I know it's an interest of yours and Senator Garn's as well.

Explain why, in the context of the way you put it after the stock market shocks of several weeks ago, that you think that there is increased danger of the market system unraveling, that's what I take what you mean to say, if this kind of financial change and consolidation isn't made.

Explain that more fully for me.

Mr. **Freeman**. I think the best way to put it is that not only did I, but I think the rest of senior management at American Express, read very carefully both Bill Seidman's draft report—I'm not quite sure of the exact status of the report, as well as Congressman Barnard's report. We became very convinced that what they both said, one way or another, was that, having talked to the regulators of all kinds of financial institutions, that the best way to enhance and improve regulation, was to go to a system of functional regulation by separate subsidiaries. This came through loud and clear from the regulators.

That meant to us that the experts, and we are not the regulators—we are the regulated—are saying that if we don't improve the situation where they can actually do their jobs better, so the SEC and other securities regulators can look at that security subsidiary and track transactions through, that we are going heading for more trouble. That was the import of what I think were very, very fine, very dispassionate and very expert studies that led us to think that we don't want interim steps, that we've got to move on, whether it's to meet the international competition, but the real core point here is that safety and soundness principle. And those reports, I think are landmarks in suggesting that we are heading for trouble, if we don't improve that situation, and they are very well-documented reports.

Senator **Riegle**. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I would like to pursue that line of questioning as it relates to safety and soundness. I believe that if we were to simply take the route of the legislation which Chairman Proxmire and Senator Garn have put forth, we do very little, as it relates to capital formation and to enhance safety and soundness of our financial system. We are not out of the woods yet; for example Moody's will be evaluating the international debt situation in our large banks.

How do we get an infusion of capital into the system? Will we get the kind of infusion that will increase the strength of our large international banks, simply by giving them expanded powers in the securities area? Not really. Isn't that one of the concerns as we talk about safety, soundness and the ability to compete? Where do we get the capital from?

And I open it up to you gentlemen.

Mr. MORTON. Well, if I may just begin, and I am sure that the bankers with me may have other things to say about it, but I feel that that capital is largely going to come from nonfinancial institutions.

Senator D'AMATO. You mean the corporate side, such as commerce?

Mr. MORTON. Yes. That is exactly what I mean.

Senator D'AMATO. And you mean IBM, for example, and others like that might put some money in that system that otherwise would be precluded?

Mr. MORTON. I believe that will certainly happen, and we certainly have seen it happen with companies like General Electric, General Motors, Ford Motor Co., and a lot of other large commercial institutions that are already in the financial services business.

Senator D'AMATO. Mr. Morton, and any of your colleagues: I ask you to be mindful of the criticism that S. 1905 is a radical departure from the separation of banking and commerce, and somehow, I guess it is Gerry Corrigan who is championing this argument, that somehow commerce should not be permitted to have its participation and puts its dollars into the system.

So if you would—is S. 1905 such a radical departure that we can't ensure the safety and soundness of the depositories and of the FDIC?

NO DISTINCTION BETWEEN BANKING AND COMMERCE

Mr. MORTON. Senator, I think that your bill recognizes the economic facts of life. There is no separation between banking and commerce in this country right now. And what we need is a regulatory scheme that recognizes that fact, indeed may encourage that fact, to some extent, but certainly, regulates us in a way that makes sense as to the kind of institutions that we are. The Financial Services Council says, here we are, please regulate us in some comprehensive fashion that recognizes the marketplace as it exists today, not as people wish it were. And perhaps you have something to say.

Mr. FITZPATRICK. Senator, I think you make a good point. In our business, we are in the depository business. We do have the benefit of Federal insurance. We do have access to borrowings from the Federal Home Loan Bank System, et cetera, et cetera, et cetera, and yet in our business, there really is no distinction between commerce and banking, because a number of large commercial firms own large savings and loan associations, and as far as we are aware, there has been no indication, no instance so far of any difficulty. In fact, I think the central point is the one you made. Where is the capital going to come from? If we are going to solve some of the problems we have, but more importantly provide the services that we would like to provide, the industry needs more capital, and one of the sources, aside from right now when it's coming from overseas, one of the sources is going to be the large industrial and commercial companies. We don't see anything wrong with that, and in fact, as Mr. Morton said, it's already here. We just haven't recognized it from a legislative point of view.

Mr. **Freeman**. I think, Senator, in response to your point, capital starvation is becoming one of the increasing problems of the whole financial services industry. Where we are going to get the capital for the future is one of our most critical problems. I think S. 1905 allows not only what my colleagues have said, but also by creating separate subsidiaries, allows the external investor to pick and choose. You want all or some, you want to be in the thrift business, you want to be in banking, you want to be in securities or you want all of it. So you have the flexibility to bring in capital.

I think the separation of commerce and finance is something that we have seen in the past that doesn't really exist much any more.

There is another point on Glass-Steagall. We are really not suggesting repeal. S. 1905 does not have underwriting of securities and banking in the same company. They are in completely different subsidiaries. So you are not repealing the guts of Glass-Steagall or combining them in one place. You put them in separate units, regulated by separate people on a functional basis. So you protected the rationale behind Glass-Steagall and have taken away the parts of it that have obstructed capital moving in.

Mr. **Bogaard**. Senator D'Amato, I agree with what has been said in response to your question. And I would like to take just a moment to address the question of whether S. 1905 is a radical departure or a dramatic change in what we have been doing, and I can't deny that there are some interesting and innovative features to the legislation, but I would say, and this has been said in another way by other members of the panel, that it represents what is happening in the marketplace, and I think a reasonable evolution of what is taking place in the marketplace.

Second, it is not radical, because it substantially confirms the existing regulatory structure for insurance and securities, the dual banking system in the United States and in other ways, confirms and ratifies, through the functional regulation concept, the existing regulatory scheme.

Third, it avoids unnecessary overlapping of regulatory jurisdiction, and in that regard, it is more likely than not—more likely than otherwise—to lead to smoother operation of our financial system in the United States.

And finally, I would argue that the new legislation directs attention to the problems that are developing in the marketplace, problems of dealing with options and futures, which, at least, are one of the possible problems that contributed to Black Monday. And in that regard, by directing attention in a more rational, realistic way, to what is taking place in the financial markets of the United States, I think it is likely to contribute to a smoother operation.

Senator D'AMATO. Mr. Chairman, my time is up, although I would like to make an observation. If we are really talking about addressing the problems of the system, simply the expansion of some securities activities, when you have a decline in the securities area, itself, particularly as it relates to municipal bonds, is not going to really give the kind of capital infusion that our banks are talking about, number one.

Second, by setting up the kind of standards and firewall contained in S. 1905, we give greater protection to the depository institution than presently exist. Third, it would seem to me that the legitimate fears and considerations, as it relates to the independent insurance agents, can be dealt with. I want to commend those of you in the Financial Services Council that have worked with us to develop a rather comprehensive package, and I think it is rather shameful that we continue to say it won't happen, because it's never happened before.

This is one of the five Senators who voted against that Garn bill prior, and if I could come to the position that I have and say, let's really harness America's dollars in this system and do it in a sound, safe way, why I think, you know, St. Jude worked for me, it might even work for some of the Members in the House! [Laughter.]

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator D'Amato. Senator Chafee.

Senator CHAFEE. Mr. Chairman, I've just got one question, and so that Senator D'Amato can have the balance of my time.

SEVERE PENALTIES

My question just dealt with, in this particular measure that you folks are supporting, namely, the D'Amato bill, S.1905, those penalties that are in there seem quite severe. How did you arrive at those penalties, or how did you arrive at your support for such penalties, a quarter of a million dollars and twice the individual annual rate of total compensation and prison terms?

Mr. MORTON. Well, Senator, briefly, we wanted to reassure people like you, maybe we have succeeded in doing that and maybe not, that we are not after deregulation. We are trying to strengthen regulation on a functional basis of these institutions. We think the best way to prevent people from breaking laws is make it painful for them when they do, and so that is the fundamental approach that we used.

Senator CHAFEE. Well, you always worry about in these sentences is that you get them so stiff that no judge will levy them. I mean, the consequences are so severe.

The other questions I had have already been answered, so if it is all right with the chairman, Senator D'Amato can take the balance of my time.

Mr. MORTON. Senator, may I also say, we would certainly be happy to work with the Senator on any reasonable modification. We know this is not a final version of the bill.

Senator D'AMATO. In responding to the question that Senator Chafee put forth, I might say that Banking Committee Counsel included those criminal penalties. I remain concerned that the fiduciary responsibilities that we talked about will be kept and will be sacrosanct in such a way that institutions are going to know if they become involved in the kind of self-dealing, and that as they begin to pierce that corporate veil that there are very real penalties as it relates to both the criminal and civil to prevent such sharp practices. Senator Chafee the provisions were intended to set the underpinnings to prohibit that kind of the bank dealing with the insurance company and creating a situation where people are told, well, if you want this loan, you had better go on over there and use our insurance or our real estate services or our other, which are on the other side of that firewall. These penalties are designed to give legitimacy to the firewall by demonstrating that there would be strong criminal as well as civil penalties for violations. And that was the nature in which we approached this matter, because there was so much concern about there being an undue concentration and the lack of competition that might result.

And I think that is an excellent question, and that was the theory behind it, and certainly, it doesn't mean that if some of those penalties and sentences are not open to review, as it relates to those who might violate them.

Senator CHAFEE. Mr. Chairman, I have a statement I would like to put in the record.

Senator RIEGLE. We would be happy to make that part of the record.

It seems to me that the legislation that we passed that created the moratorium, warts and all, because it is hard to get perfect legislative products, and some people like them, some don't, but clearly, we've got a very active debate going, and I think this debate is different than other debates we have had in the past, in the sense that we've got proposals on the table. You've come in today in your group to react in detail to proposals, new proposals that are on the table, as have others. And so I think there is a kind of movement in this discussion that is healthy and constructive and different than we have seen, and certainly events out in the marketplace continue to change. Whether we act or don't act, the world is sort of moving ahead with us or without us.

I want to take your point, Mr. Freeman, and pursue it with respect to capital starvation and the issue—the degree to which legislation here can solve that problem, both understanding the anatomy of that problem and thinking about what the solution to the capital starvation problem is.

I see that as a very serious matter. I am far less clear at the moment on precisely how we solve it, because it seems to me, at the base, our capital starvation problem is a low savings rate problem, and however, you amalgamate capital, you know, if you are not saving very much, and you are consuming a lot, public and private, you are going to have a capital problem. We have one. And I think interest rates over time are likely to reflect that even more than they do now.

Here is the question I would like to pose.

Let's assume we have the D'Amato-Cranston approach as an accomplished fact, and so we have now got banking, securities business and commercial activity generally all combined under an affiliated company with the various separate segments, and I want to take the issue of how capital, how we solve the capital insufficiency problem or how capital moves around. And in my own mind, I say to myself, if you had a firm like that, we are obviously not going to let the bank with the Federal Deposit guarantees and the Federal Reserve connections funnel capital over into the other entities. In fact, we are going to have all kinds of limitations to prevent that, and if we find that it happens through or around firewalls, presumably even send people to jail.

So we are not going to have capital flows going in that direction.

The question is, Will we have capital flows coming back the other direction? And that is worth testing a little bit, because, you know, I've got automobile companies in my State now that are moving into financial services, as you well know, and other kinds of commercial ventures coming in different ways, similar to some of the companies represented at the table here.

I am hard-pressed in my own mind, just in terms of the logic of it, to see how a commercial firm is going to decide, through an affiliation under an umbrella, to take some of its scarce capital and transfer it over into the bank, if the bank needs capital, talking about the banking operation per se or how some other affiliated part of a large umbrella group is going to say, well, I'm going to draw down my capital account, because the bank over here needs money.

I have a hard time seeing how capital is going to either flow from the bank to the other parts of the affiliated group or from the other areas over to the bank. And so I am wondering if that is realistic to assume that that would happen or could happen to a degree that, in fact, gets at the issue of capital starvation. I see the problem of capital starvation above a certain size, but I am not sure that I see precisely how that problem is being solved by this arrangement.

Now maybe you see it, and I don't, in which case, that is what I would like to hear. So who would like to take a crack at it?

Mr. MORTON. Well, let me start, and then I am sure the other Council members here may have things to say. I think there are at least two responses to your question, Senator. First of all, I think that many commercial firms are better capitalized than many financial firms. And certainly, in our case, while we were only a life insurance company to begin with, we then acquired a consumer bank, and a retail securities firm, and a property and casualty insurer. And, at all times, one of our major concerns was to be sure that these financial subsidiaries were appropriately capitalized and we are still concerned with that.

You can always theoretically walk away from financial institutions, but when they belong to you, if they need capital, you are ments which have prevented banks and companies affiliated with thrift institutions from acquiring securities firms, Wall Street gains capital and a new competitive capacity at a particularly critical time. Similarly, insurers, commercial banks and other financial service providers would necessarily become more efficient and more competitive.

The Need For Comprehensive Reform

As the Committee has heard in the course of its extensive hearings over the past several years, revolutionary changes have occurred in the financial services marketplace. The securitization of assets, erosion of market barriers at home and removal of barriers abroad, the institutionalization of savings, as well as product innovations fostered by technological advancement are but a few of the fundamental forces reshaping the marketplace.

The globalization of the financial services marketplace seemed to many to be a mere academic notion in the late 1970's. Today, no one disputes the premise that financial markets are necessarily global and irretrievably linked. Against that background, any initiative which appeals only to domestic, parochial considerations places this country at a significant competitive disadvantage and leaves our financial services industry vulnerable.

Conclusion

In sum, the financial services industry has changed. Regulation has not. As a result, customers are being shortchanged, America is falling behind, and time is running out.

Congress can and should conform yesterday's regulation to today's marketplace. The economic inefficiencies and unnecessary costs are well-documented. The competitive imbalance between providers is beyond dispute. The bill which affords all an equal opportunity to compete and to meet the needs of their customers, S. 1905, is now before you.

We pledge our cooperation to work with the Committee to achieve meaningful reform in this Congress.

much more likely to give them capital than not give them capital and walk away from them.

Senator **Riegle**. Well, why doesn't that impulse also apply going the other way. Why isn't the bank, if the affiliate is in trouble, feeling the same impulse to get the money over there?

Mr. **Morton**. Well, I think, as you have said, that can't happen under the law. And I think that you make it so that it cannot happen. If a bank is a bank, it is going to be regulated by the banking officials. They are going to require the same kind of standards that they now have, which I believe are 6 percent capital base, and in addition, S 1905 would give the regulators power to, on an individual basis, add another 3 percent to that capital, to require that capital be increased. Our belief is that functional regulation is going to make those firms sound.

As far as where the additional capital is going to come from, I would say, (a) from commerce, what is now called commerce, and (b) from letting a lot more players into the business, having innovative products, more attractive products to customers and doing what you hope would happen, and that is, trying to get the savings rate increased just because customers are going to be attracted to the types of products that they are not now attracted to.

That is my response, and perhaps other members of the Council would want to respond.

Mr. **Freeman**. Let me perhaps add a point, if I might, Senator Riegle. I don't think that S. 1905 guarantees more capital. I think lack of action pretty much guarantees that no capital of consequence will move in. I think the objective is to create a framework where capital can, if there is a return there, move in a fairly convenient way.

One way of looking at it is the way that other competitors of my company have looked at S. 1905. In a sense, it creates a structure similar to my company, where you have American Express Co., with maybe 400 or 500 people, which is the parent holding company, and is the source of capital for the subsidiaries. By creating separate subsidiaries such as Shearson Lehman, we can put needed capital there. We had various options. We put some capital in from the parent company. And we went to Japan, to Nippon Life, and they bought a piece of it, and we also took part of it public.

We have another major subsidiary, First Data Resources, which is in the financial data processing business. We have become the largest private sector employer in Nebraska. We sold part of that to the public to raise capital for that.

This kind of parent holding company and subsidiaries really does give you a lot more flexibility in raising capital.

And second, I would go back to my basic point. The financial services industry would be much more attractive to bring capital either from existing financial companies or from commercial companies, nonfinancial companies, if there is higher quality regulation and not the kind of omelet that now exists. It is getting more and more risky. Therefore, you need much greater capital or nobody is going to come in. So I think that S. 1905 does not guarantee the massive amounts of capital, but it does facilitate the movement of capital, and the lack of action or piecemeal approach inhibits it.

I also agree that you have to look at the savings rates and other things like that in the development of capital. That is another issue that is not addressed in these bills, and I don't see how it would be addressed in this particular or any other bill, but I think this bill would enhance the probabilities of capital flowing in and other piecemeal approaches or nonaction decrease the probabilities of capital flowing in.

Senator **Riegle**. Do either of the other two of you want to comment specifically on that capital formation, capital attractiveness issue?

Mr. **Fitzpatrick**. I would just like to make one point, Senator, in addition to what Mr. Freeman just said. S. 1905 does provide that if the management, the holding company management isn't prepared to maintain the capital of the bank, it can be forced to divest the bank or the savings and loan or the insured depository. And I think, particularly with publicly held companies, that is essentially an option that is not very attractive, so that internally, the bill does at least go part of the way to directing where the available capital ought to be invested.

But in terms of raising external capital, I was going to make the same comment that was just made, that one of the benefits of this structure is that it does provide substantial flexibility. If you have a series of different businesses, functionally regulated, you can deal with each one on its own merits. Some, it may be appropriate to share ownership with the public. Some, it may be appropriate to joint venture. Some it may be appropriate to capitalize in ways other than equity capital. But it offers flexibility that we don't presently have. It seems to me, one of the problems with—one of the issues with the bank capital problem, and to some extent, the savings and loan capital problem is, there is no other resource. The bank holding company, essentially, only owns the bank. So it is, in a sense, chasing its own tail.

From an investment standpoint, and we certainly make investments, the opportunity to have the flexibility which the bill would permit, I think, would be very attractive.

TIE-IN SALES

Senator **Riegle**. Now one other concern that many people have expressed—we haven't talked very much about it today in your group—is the concern about possible tie-in sales or using the credit power of the bank as a lever to force customers who want credit to eat other services that they may or may not want. And that question gets addressed to a variety of devices, separate affiliates, having prohibitions against tie-in sales, presumably having penalties. Some people suggest different names, so that you are not, in a sense, taking a subtle ride off the FDIC or FSLIC symbol on the window to make it seem as if some other product is somehow safer and sounder or a little more attractive to somebody.

To the extent that you—the devices are found to really prevent the tie-in relationships or the cross marketing, if you will, I mean, to really seal it off, especially from the banking functions, if you have got a different kind of a firewall that basically takes a way that aspect of it, how important is that? I mean, what do you lose if you lose that?

Mr. **Morton**. Well——

Senator **Riegle**. I know you would like to have it, if you are going to argue for that point of view, but I would like to hear you talk about it.

Mr. **Morton**. Certainly. As you know, we believe strongly that tie-in sales are illegal and should remain so, and S. 1905—Senator D'Amato's bill and Senator Cranston's bill—does include the existing prohibitions against tie-in sales, and I believe the penalties may have been increased as well. However, an absolute prohibition against what is broadly called "cross selling," "cross marketing" would be inappropriate, because we do believe that one of the advantages of being a diversified financial services institution is the efficiencies that would result to the customer from being able to buy more than one product from the corporation, thus strengthening the corporation, reducing the price of the product and increasing the service. Now you can't make that a condition because that would be a tie-in sale.

What you have to be able to do, is to take a list of John Hancock policyholders, for example, and send them, when we send them out their premium notice, a list of other services that are available through the John Hancock organization. If they are interested, here is how you can contact them.

Now it seems to me that that is a legitimate sales device that exerts no pressure on the customer whatsoever, other than providing information. There have been proposals that are so broad, they would prohibit that kind of sales solicitation. Of course, I think all of us would be opposed to those types of proposals.

Senator **Riegle**. Let me ask you this, Mr. Morton, isn't there a—I am a John Hancock policy holder, and so I——

Mr. **Morton**. Congratulations.

Senator **Riegle** [continuing]. And so I get your mail. [Laughter.]

Mr. **Morton**. We are glad to have you.

Senator **Riegle**. Isn't there a difference between even an insurance company sending out a flier and selling whatever else it may be selling in an envelope or invoice, isn't that somewhat different than a bank, what is understood to be a bank, who is sending out a monthly statement of a checking account or sending out a slip that says that your mortgage payment is due or that your commercial loan has to be rolled over, if you are small business, and there is an advertisement in there that, "By the way, we sell the following six other services" or whatever it happens to be? That doesn't trouble you? You don't see a difference between the bank doing that, when you've got to go, and if you are a creditor of the bank, and you have got to go to the bank and get credit and extend credit and add to credit and over a period of time? You don't see any problem with that?

Mr. **Morton**. I believe that if it is handled properly, Senator, there is no problem with that. I think you have to be very careful about timing on this, that you don't make it in any way look like a condition. But certainly, when I have taken out mortgages in my lifetime, usually shortly after that, I have got such notices from the bank that said, if you die, wouldn't it be nice if the mortgage were paid off, and we have the name of somebody that will contact you, if you write your name and send it in.

But that is after the transaction has been completed. I have my loan. And I think there is nothing wrong with that kind of solicitation.

Senator RIEGLE. Yes. I guess too, you know, personal examples always have a value. I think, you know, you are a pretty strong customer when you walk into the bank, as opposed to maybe somebody that—isn't quite as strong a customer as you are.

Just looking at things over a long period of time, banks do have a special role in that area, that they play, and it depends on the community and the amount of competition, and so forth. Some places there is less of it. But bankers and people who are in the banking business, who extend or don't extend credit, not just individuals, but to businesses, particularly, are in a very, very strong position, not always, but in many cases. And depending upon the strength of the borrower, and you are a pretty strong borrower, when you walk in, and a pretty sophisticated borrower, it seems to me, you know, you are in one kind of a situation.

I wonder, though, how readily one can apply that example to everybody else in the country?

Mr. MORTON. I think you do have to be very careful, Senator. I am sure you are aware that our bill wouldn't allow the bank itself to provide these other products. It would have to be done through a separate affiliate.

Senator RIEGLE. No, I understand.

Mr. MORTON. The bank would refer you to an affiliate. But still, I think the dangers that you describe are real, and we believe that those kind of dangers are adequately dealt with by a rational regulatory system and can be dealt with.

Mr. FITZPATRICK. Senator, I think the other thing is that a growing proportion of the credit available in the country is coming from noninsured institutions.

Senator RIEGLE. I think that is an important point.

Mr. FITZPATRICK. Automobile companies, insurance companies, finance companies, department stores, gasoline companies, et cetera. And you can take that argument all the way through. Why is it that it is not socially bad for a customer to walk into the securities broker and be handed a brochure about some other service, but when that happens in the bank, it is some calamity that is going to occur?

Senator RIEGLE. Well, there is this difference, it seems to me, I mean, and you can make lots of different examples that make that not a clear-cut question one way or the other, but, as opposed to some—you can go down to the finance company, and you can borrow money, as well. There is no Federal deposit insurance. There is an entirely different situation there. They don't have access to the Fed window. That is an entirely different kind of situation than if you go down to a federally insured institution, whose reserves are multiplied under a formula through the Federal Reserve System to create lending power for a whole variety of purposes, and where they have access to the Fed window, that is a very different kind of lender than a lender who doesn't have that. Now you've got some hybrid lenders who, in effect, have part of that, because the system has become very mixed, but I don't know that you can simply ignore those distinctions and sort of sweep everybody together, because it seems to me, banks that have Federal deposit insurance and access to the payment system in the Fed window, are different than any other lending institution that doesn't have precisely those things.

Mr. **Fitzpatrick**. I think that is true, but as Mr. Morton said, in S. 1905, the bank would not be in the insurance business or the securities business or some of these other businesses. So what it really is doing is introducing its customer to an affiliate, and if the concern is that somehow or other, the bank is going to use the Federal safety net to promote these other businesses, it couldn't happen with this proposal.

Mr. **Freeman**. The only thing I would like to add is, the other day the general counsel came in my office and said, "Freeman, have you read this? Have you seen these penalties, that if we do such-and-such and such-and-such, we are going to jail?" Of course, I said, "Look, I'm in charge of getting the legislation. You're in charge of enforcing it." [Laughter.]

But I think the penalties are a very important part of this, very important, and I agree with what has been said by my colleagues. There is a distinction between cross marketing by different companies and really tie-in sales. Tie-in sales are bad and become illegal with severe penalties.

Senator **D'Amato**. If I might, Mr. Freeman, you've correctly identified the reasons those penalty provisions were included in S. 1905. They were to answer the very, very legitimate concerns that my colleague raises, and which this committee has previously raised to ensure that particularly the small customers will not feel that they have got to subscribe to all of the services of that financial institution. They need not fear that somehow the builder, the home owner, the mortgage, the business entrepreneur, will not be denied credit if they fail to purchase other products. That is why we have spelled out very clearly, not only civil penalties, but also criminal penalties, because it is criminal to coerce someone or to create even the fear that unless they take these other services, that somehow they will be denied access to credit.

The question is, How do we protect them to ensure that coersion, whether explicit or implicit, is prohibited. I think we can do legislatively, to ensure that customers are not subjected to coercive practices, which I think would be a terrible blow to our system and to our process.

So I share my colleague's concern, and I say that with all sincerity, and if there is any way in which we can further strengthen, without doing, without creating such a monstrous burden on business, that they are just totally fearful of any kind of activity, why I would certainly look forward to working with you on that.

Senator **Riegle**. One other question, gentlemen, different area, the concentration issue. If you look at the long history of financial services in this country, as they have been evolving and changing, the economy has been changing, and we have had a very diverse system. We have had a lot of players, a lot of banks, large and small, lots of everybody under the sun in the financial services business, insurance, what have you, mutual funds, securities, what have you.

CONCENTRATION OF SERVICES

The rest of the world hasn't necessarily had the same pattern. There is much greater concentration in certain other places than there is here, and that is partly just the style of our country. Some people have raised the issue, if we start down this road in the fashion that you are all advocating here, that we are going to find ourselves with a real change in terms of concentration before very long, and that we will end up with a handful of really dominant players, and for good or ill, but that that will be a fundamental change in the pattern, and a lot of the small fry that have been out there serving market niches all over the country, whether they be banks or other financial service companies, will dry up or be squeezed out or be pulled into the smaller number of larger and larger conglomerates that do all the business.

Tell us why either that won't happen, or if it does happen, it is a good thing? [Laughter.]

Mr. **Morton**. I don't think it would be a good thing if we ended up with all the financial services industry in this country concentrated in very few hands. I don't think it will happen. And one of the reasons why I don't think it will is because, historically, that has not happened, and time and time again, I have heard worries that things were going to happen, as a result of economic events or laws, and certainly, there has been no untoward concentration of economic power.

I think perhaps the most salient example was when negotiated commissions in the securities business were instituted, and what did happen was that there was a substantial shake up of the securities business, but there are still very strong, thriving regional firms. The major ones have not gobbled up all the market, and I think they are unlikely to.

Our approach increases competition rather than decreases competition, because it allows a lot more players in the game, and we believe that that is going to be the overwhelming result of this kind of a regulatory scheme.

Now apart from that, S. 1905 hasn't changed the fundamental protections which prevent that from happening, other than the ownership approach to the separation of commerce and banking. Depository institution holding companies still have to get permission for a change in bank ownership or change in thrift ownership in order to acquire a bank or thrift. The antitrust laws are still in effect. We believe that there are adequate safeguards, and if there aren't, I think there is nobody in the Financial Services Council that would object to taking whatever kind of reasonable measures, it would seem, in order to prevent that from happening.

I don't think you could prevent it from happening by requiring that one of the 25 largest banks can't merge with one of the 25 largest securities firms. That, it seems to me, is playing a game by the numbers, which is almost always counterproductive and leads to loopholes, and so forth. But I think enlightened, tough regulatory schemes can ensure that that won't happen. But frankly, I believe the marketplace is much more likely to prevent that from happening.

Mr. **Freeman**. If I could add a comment, Senator. From the point of view of payment systems, I recall in 1975, the Electronics Fund Transfer Commission reported that cash would be gone in 5 or 10 years, and it isn't. You've got more machines, but you also have cash. Now we were told that our business of travelers' checks would be gone in 5 or 10 years, and every year we sell more. The same is true of the money order business. In other words, in financial services, new things come along, but the new does not displace the old. This gets around to concentration, because anybody that's got a good product can do well. It's been clearly shown that in financial services, that when big company comes up against small company in a local market, small always beats big. I recall Walter Wriston saying this five times over 10 years in this room, when they attempted to go up to northern and western New York. And I think this bill, this approach does not favor big or small. It favors preservation of diversity, and therefore, I would say somewhat anticoncentration. Where you do get concentration fast is when you have some kind of catastrophe. You are seeing some concentration today in the securities business in the United States, because of recent events—the events of the last month or two.

I think this bill with enhanced regulation would go a long way to avoiding that kind of problem and triggering this concentration. I think it would be prodispersion rather than proconcentration.

Mr. **Bogaard**. Concentration, I think, Senator, needs to be dealt with. I agree with it as an issue, but I am confident that when the studies are done, that the issue can be resolved in a way that it doesn't need artificial solutions. I think of our experience in California, where for many years, the Bank of America was the largest bank in the country. Security is the sixth largest bank in the country. First Interstate is the eighth or ninth largest banking organization in the country, and at the same time there are over 400 banks in the State of California which are operating as an industry in a very vital and dynamic way and providing important services to their segments of the marketplace.

Senator **Riegle**. Gentlemen, thank you very much for coming and for your prepared testimony and your responses.

Let me now call Mr. Norbert McCrady to the witness table, who is the executive director of state and national affairs for the Independent Bankers of Minnesota, and I will begin by thanking Mr. McCrady for his patience, and these are complex issues, as you can well appreciate. It is not always possible to move as rapidly as we might like, in order to get through the witnesses, the testimony and the questions that are necessary, we will pause just a minute to let those that are going to leave make their way out and those that are going to stay will have fine seats.

Senator **Riegle**. Mr. McCrady, let's hear from you now.

STATEMENT OF NORBERT A. McCRADY, EXECUTIVE DIRECTOR, STATE AND NATIONAL AFFAIRS, INDEPENDENT BANKERS OF MINNESOTA

Mr. **McCrady**. Thank you, Mr. Chairman.

Mr. Chairman and the committee: I am Norbert McCrady. I am executive director for state and national affairs, Independent Bankers of Minnesota.

Today I am here to speak in opposition to the proposed repeal of sections 20 and 32 of the Glass-Steagall Act and to comment on the related issues before your committee. Until minutes before my departure for this hearing, Mr. Chairman, I was authorized to speak for the same four State independent banker associations that met with you to discuss our opposition to your proposal nearly 3 months ago. At this point I am representing three of those four—they being North Dakota, South Dakota, and Minnesota.

I don't enjoy appearing in opposition to a proposal put forth by you, Mr. Chairman, because we have always found you to be a champion of small business, including small banks, with regards to previous legislation.

We don't have such a short memory that we have forgotten the fine support forthcoming from the Senate in enacting secondary market, debt amortization, and loophole closing legislation. We appreciated the concern and support of Senate Members then and we express that appreciation again at this time. Nonetheless, I appear before this committee today to state our strong and clearcut opposition to the proposed changes contemplated by your legislation, as well as the bill introduced by Senator Wirth and Senator Graham, and by Senators D'Amato and Cranston. One can hardly be accused of taking the path of least resistance under these circumstances.

OPPOSITION TO ALL LEGISLATIVE PROPOSALS

Today, bankers throughout our Nation have had the opportunity to hear the pros and cons of these proposals many times over. As a result, there are very few who have not made up their minds as to whether they are for it or against it.

The bankers we speak for here today are convinced this tampering with the Glass-Steagall Act would result in an acceleration of the already serious concentration threat in our Nation. This would lead to more money being controlled by fewer banks and bank holding companies with the trend toward concentration being both hard to deny and impossible to reverse. Try as one may, there are virtually no beneficial offsets in these proposals that could be put to use in helping communities and community banks in their struggle for survival.

Just as an aside, I would say that the economic strength that comes with concentration may not be even as dangerous as the political strength that comes with concentration.

Senator RIEGLE. How do you mean that?

Mr. McCRADY. I have been a lobbyist for 35 years, sir, and I come from a State that's very heavily dominated by two major system banking organizations—First Bank and Norwest Bank Corp. While their operations are strictly legal, their overwhelming power in the political arena is—you don't need a magnifying glass to see it. It is so dominant that even if you will permit me, sir, as a Republican, I find it to be something that must be changed if we are to restore some balance so that all people have a fair say in what goes on in our political system and in our societal system.

Inasmuch as the Nation's money supply is considered to be finite, it stands to reason that as laws are changed permitting more banks to become bigger and bigger banks to become more powerful, the real losers are not only small and medium sized banks, but small and medium sized businesses, and farmers and Main Street merchants and the unorganized members of our society who are helpless to fight back.

We have all heard the assurances that we needn't worry about concentration. However, for several years now, we have seen merger after merger after merger, without objection by this administration. The product of this merger activity has not been more jobs or profits. Rather, it has been layoffs, shutdowns and the selling off of assets.

The airline industry is a prime example of the deregulated industry that was to have stimulated competition and avoided concentration. But today, after a spate of mergers, that industry is greatly more concentrated than it was before deregulation and virtual monopolies dominate most airports.

Realistically, Mr. Chairman, there is not going to be any "opening of the gate" for the banks that have their eyes on the securities industry without that "gate" staying open until the securities industry collects a trophy of equal rank from the banking industry.

We already have a problem in the lesser populated communities and in the rural sector of our Nation as the result of the mass exodus from those parts of the Nation by our largest regional and money center banks. Like a giant yo-yo, these visitors from metropolia come and they go. They come when the going is good and they go when the going gets tough. To some, that may sound like "good business." To the many communities that have suffered that indignity during this most recent economic downturn, it stinks. When the big sprawling giants pull out, it isn't as though the situation is all that inviting for a new bank to start up de novo. Remember how history repeats itself. About the time the economy begins to recover and the new bank is just getting on its feet, in comes the big bank once more, to undercut the business relationships between the new bank and its best customers. Distant boardroom policies never vary to any great degree: "Go after the good loan business and leave the rest for the local lenders." This of course spells trouble for local lenders and ultimately for the community.

Earlier testimony made it sound as though this legislation would benefit small banks if "they thought hard enough." Let me identify what we call a small bank out in the Midwest. The average size of our member banks in Minnesota is $19 million. They serve communities that are a vital part of our broad and diverse society. There are several thousand such banks throughout the Midwest and as others have testified before me it will take more than powers to solve their problems.

Profitability of small banks is greatly affected by the management of the economy by those in charge of our government. Today our banks have been hard hit by a farm depression and an energy depression. I think we can place a fair share of the cause of these depressions on government policies that didn't work.

Despite this, our bankers believe they can continue to provide the banking services that our customers need if Congress deals with problems caused by the automobile industry for instance that advertises 2.9 percent financing while they are paying 7 percent or more for those funds.

Mr. Chairman, if there is any 2.9 percent money out there, the Federal Government should be the first in line to borrow all they can get their hands on to service our national debt.

Further damage to small banks is caused when thrift institutions pay deposit rates well in excess of what safety and soundness considerations would permit. This leads to imprudent loan decisions and I need not tell you the condition this has resulted in for that industry. Thrift industry regulators have not dealt firmly with these practices and the distortion of interest yields and of loan rates has caused havoc throughout the financial institutions industry.

Yesterday's "American Banker" reports an example of the kind of pressures facing independent banks—the Chicago price and premium wars.

These institutions are paying more to attract deposits than they can justify on the basis of what they can hope to earn in their local marketplace. It's called premium bidding for deposits.

Regulators need a legislative directive from Congress to assure that stability of the banking system is not threatened by allowing such pricing practices being indulged in by auto giants and banking giants and the thrift industry.

Financial giants that engage in other lines of business to push the small banks out of business deserve a penalty; not a reward.

Facts and figures show that our small businesses in this country support creativity and innovation and provide the working capital that keeps our economy growing. A vast majority of the new jobs created each year are jobs in the small business sector. Small business is largely financed by small community banks.

When lending decisions are made at a distance, by money center or regional banks, small businesses are greatly disadvantaged. We work closely with small businesses in Minnesota and they are not clamoring for the right to have banks issue commercial paper. They continue to need traditional banking services; working capital loans, short term financings. In those instances where it makes economic sense to go public, there are underwriters ready to provide that service. The proliferation of banks or bank-like offices that would result from securities industry banking would be devastating to the small banks of this nation.

REPEAL OF GLASS-STEAGALL WILL NOT SOLVE THE PROBLEMS

The remedy for these problems is not dealt with by this legislation. Repeal of Glass-Steagall would intensify the problems, not resolve them.

Congress has heard testimony from a number of people who admit that obtaining new powers isn't really going to help solve the profitability problems of the large banks. The commercial paper market operates on paper thin margins which means that banks cannot seriously look to that activity as a means of replacing lost profits. Chairman Greenspan appears to concur with that opinion in his testimony.

Let me say that if this legislation is not going to solve the problems of the large banks, it certainly will not help small banks. And it is a matter of urgency that you find remedies that will enable small banks to continue in their important community role.

I have reviewed the testimony given by the consumer organizations before the House Banking Committee. They fail to see where any benefits for consumers will result from the repeal of Glass-Steagall. Data from the seven county metropolitan area in Minnesota—this includes St. Paul and Minneapolis—will bear them out. At the end of 1982, Minnesota regional giants, First Bank and Norwest, booked consumer loans for only 22 and 26 percent, respectively, of total loans. In contrast, independent banks, with total lending of about the same magnitude as Norwest ($3.7 billion), had 53 percent in consumer loans. Independent banks are highly responsive to consumer needs.

I fail to experience shock or even surprise over the fact that all the Federal regulators agree that Glass-Steagall should be repealed. It would be naive to expect anything different of these appointees of the present administration. The creation of megabanks and the drastic reduction in the number of small banks is the policy that became operative when this administration took office and nothing has changed.

The three proposals on your table do nothing to help small banks survive. In essence what these bills will do, in varying degrees, is to bring back under a different guise the nonbank bank. We have consistently opposed nonbank banks. We thought we had put them to rest with the enactment of H.R. 27.

Earlier testimony before this committee made it sound as though the position of the IBAA and the proponents of the Glass-Steagall repeal were only inches apart. This is absolutely not the position of our members, let me assure you. Earlier this year when the suggestion was made that powers should be expanded to permit bank holding companies to engage in the sale of municipal revenue bonds, mortgage-backed securities, commercial paper and mutual funds, we found that there was some, but not much, interest among our members in Minnesota. I think our situation was quite typical of most other States. We were able to go on record in support of these proposed expansion measures, however, because there was also no great expression of opposition. Closing the nonbank bank loophole was the most important factor in the legislative proposal before Congress at the time.

Now, as the question becomes that of repealing Glass-Steagall, a very vocal body of opposition has developed and those who would have you believe otherwise are either badly informed or are purposely ignoring the viewpoints of those who disagree with them.

While this may sound selfish or trite—or both—we who represent the smaller, independent, community banks would like it to be known that "we weren't born yesterday" and furthermore, we are intent on fighting to make certain we aren't dead tomorrow.

There are things in this legislative proposal that might, under some circumstances, be used by a limited number of our members. None would carry sufficient weight to merit any substantial tradeoffs. Certainly there is going to be no acquiescence on the proposed repeal of Glass-Steagall. We stand ready to carry out the expansion of powers as originally set forth in S. 790. Any legislation that goes beyond that will meet our firm opposition.

I thank you, Mr. Chairman and members of the committee, for this opportunity to address the committee. I would be willing to answer any questions you may have.

Senator RIEGLE. Mr. McCrady, thank you. I have enjoyed your comments and I can see why you have been a successful man in your line of work for 30 years and I appreciate your frankness.

I think you have made a number of good points. I have appreciated hearing them. I may say to you that you may have some questions from members of the committee and, if so, we will send them to you. Thank you.

Mr. McCRADY. Very good, sir.

Senator RIEGLE. Thank you very much for your testimony.

The committee is in recess.

[Whereupon, at 1 p.m., the hearing was adjourned.]

LEGISLATIVE PROPOSALS TO RESTRUCTURE OUR FINANCIAL SYSTEM

THURSDAY, DECEMBER 10, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Shelby, Graham, Wirth, Garn, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

This morning we conclude our series of hearings on the repeal of Glass-Steagall and we are very honored to have two highly distinguished witnesses. Mr. Heimann is always an excellent witness. He has appeared before the committee before. He's a man who has had solid practical experience both as a public official and in the private sector and while he may find the public sector more fun, I think he finds the private sector more remunerative.

Also, we are very honored to have Mr. Corrigan. Mr. Corrigan has written profoundly on this subject of financial restructuring which of course is our problem. In fact, his writings have been drafted into legislation introduced by two members of this committee and that is among the three major bills we're going to consider this morning.

So we're most honored to have you, gentlemen. While this is the last hearing on this subject in this series before we have a markup, it certainly isn't the least. In fact, in many ways, considering the quality, I think it's probably the best.

Senator Garn.

Senator GARN. Mr. Chairman, I'm just happy to welcome the witnesses. I have no opening statement today.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, I just want to welcome the witness again. I felt he made some good points several months ago when he appeared before the committee and he's got a unique proposal.

I do have an opening statement, but I would like to ask unanimous consent that that be made part of the record.

The CHAIRMAN. Without objection, so ordered.

STATEMENT OF SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, today we will address in closer detail the bill introduced by Senator Wirth and Senator Graham. We have the original author with us to share the wisdom his experience at the New York Federal Reserve Bank has given him.

I commend my colleagues for their efforts in adding viable considerations to the debate on the future of the financial services industry. I believe that we have already benefitted from the discussion on this bill. This proposal calls attention to areas that have not been addressed by other measures.

The Wirth-Graham bill establishes a National Electronic Payments Corporation. Mr. Corrigan's position enables him to see the volume transacted by the large dollar electronics payment system every day. He advocates the establishment of this corporation as necessary to guard against potential volatility that could reverberate through the financial system. Other witnesses, however, have testified that such a payments system is unnecessary. I would like to reach a consensus on such an important issue.

The Wirth-Graham bill also mandates the creation of the Financial Services Oversight Commission to accomplish its purpose of functional regulation. I cannot believe that it is necessary to add another layer of bureaucracy to the Federal Government. A 15-member panel, of whom 9 of the members would be drawn from Federal regulatory agencies, would oversee the emerging new financial services industry. I agree with a system of functional regulation but I believe that nine regulatory agencies should be enough.

Most significantly, the Wirth-Graham proposal maintains the separation of banking and commerce. We have heard a lot of testimony about the inefficency of this distinction. That separation was made over 50 years ago. I believe that it may well be time to bring financial services regulation into line with the true nature of the financial services industry.

I look forward to the testimony of our witnesses.

Thank you, Mr. Chairman.

The **Chairman**. Senator D'Amato.

OPENING REMARKS OF SENATOR D'AMATO

Senator **D'Amato**. Mr. Chairman, I would like to pay my respects to both witnesses. Both have testified numerous times. Mr. Corrigan has come forth with some very stimulating, provocative, positive legislation. We might differ a little bit. I think commerce should be provided an opportunity to participate in our economic revitalization I might say of our financial system and market system.

Having said that, Mr. Chairman, unfortunately, I have another hearing, but I would like to leave some questions for the record with your permission so that we might have the opportunity of having the wisdoms and thoughts of both Mr. Heimann and Mr. Corrigan.

The **Chairman**. Senator D'Amato, before you depart, let me just say that, as usual, your constituents tend to dominate the testimony before this committee. Today they are unanimously D'Amato constituents.

I also ask unanimous consent that a statement by Senator Dixon be printed in the record at this point.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Banking Committee wraps up the current series of hearings on banking legislative reform proposals.

We have heard from a wide variety of interested parties, and I have to say that in many ways the testimony sounds much the same as it did when I first came to the Senate in 1981. While much of the testimony may be the same, however, the world is not. Financial markets are continuing to evolve, and our regulatory framework becomes more and more inadequate to deal with the changes.

I do not want to overstate the point about the testimony being the same, because there are some important differences this time. For example, the regulators and the administration are generally united on the approach that they believe should be followed.

I want to conclude by restating three points that I have made during the previous hearings. First, I support the idea of reform, and I believe we should act before March 1. Second, I think everyone needs to be very realistic about the kind of proposal that can be enacted. We need to work to achieve what can be achieved; it makes no sense to have another congress of legislative futility. Third, the moratorium will not be extended, which means that groups can either work in a reasonable fashion with this committee to craft an acceptable bill, or resign themselves to appearing before the regulators and the courts. Continuation of the current freeze is simply not in the cards.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Corrigan, we are delighted to have you. Go right ahead, sir.

STATEMENT OF E. GERALD CORRIGAN, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. CORRIGAN. Thank you, Mr. Chairman.

I would also ask that my entire prepared statement be submitted for the record and I would like to just devote a few minutes to some parts of it.

The CHAIRMAN. Without objection, it will be printed in full in the record.

Mr. CORRIGAN. Obviously, I'm delighted to have this opportunity this morning to lend my support to the legislation that would modernize the legal framework associated with important segments of our banking and financial system and its official supervisory apparatus.

Specifically, I want to indicate my general support for S. 1886, as introduced by you and Senator Garn. I note that legislation along the lines of this bill would, in my judgment, constitute one of the most important and progressive Federal legislative initiatives in the area of banking and finance that we have seen in many years.

S. 1886 IS A FIRST STEP

In expressing my support for S. 1886, I am of course mindful of S. 1891, as introduced by Senators Graham and Wirth. I'm sure it will come as a surprise to none when I say I have some very considerable support for the broad thrust of S. 1891.

As I see it, however, the preferred approach would be to push ahead with S. 1886 and promptly return to the broader issues posed by S. 1891 and S. 1905. That approach I think is made easy by virtue of the fact that the structural approach contemplated in the Proxmire-Garn bill is compatible with the structural approach embodied in Graham-Wirth.

I also say this because even my own essay contemplated a so-called building block approach phased in over time, but I think it's very important to note that the Proxmire-Garn bill would itself get us over what I consider to be the most important single hurdle on the way to a more coherent financial structure. It's a giant step indeed.

Consistent with that building block philosophy and drawing on the spirit of the Financial Services Oversight Act, it might be useful to consider even now some kind of an instrumentality involving banking agencies together with the SEC and the CFTC. That body might provide a vehicle for an initial exploration of what steps should be taken to better rationalize the supervision of activities that cross institutional boundaries, while at the same time more systematically examine the obvious problems we face with regulatory gaps and overlaps.

Now as I see it, the case for prompt action is compelling and I've spelled out on other occasions my views on that. I don't want to repeat them today except to note that nothing that has occurred in the interim, including the market developments of October, has changed my views in this regard. On the contrary, recent developments have reinforced the case for reform, so long as that process of reform is accompanied by appropriate supervisory safeguards, a condition that has always been in the forefront of my own thinking.

Indeed, if there is one overriding lesson to be learned from the events of October, it is that the banking and financial system is just that—a system. The nature of the operational liquidity and credit interdependencies that characterize contemporary financial markets and institutions is such that the well-being of any one segment of the system is inexorably related to the well-being of the other parts of the system as a whole.

Because of this, our approach to reform and modernization must be guided by some coherent view of the system as a whole, not just a focus on its component parts, as important as they may be.

As I said, I don't want to go through at this time the specifics on that, but I would like to turn, Mr. Chairman, to the question of firewall considerations, which I think is crucial to this whole matter.

As a general matter, I enthusiastically support the use of a holding company corporate approach which is embodied in both S. 1886 and S. 1891 as the vehicle for achieving greater integration in our financial system. I say that in part because that approach can better facilitate competitive equality and functional regulation, but also because it provides an added measure of assurance that abuses can be avoided and problems more easily dealt with if and when they arise. Consistent with that view, I find the specific firewall and related provisions of S. 1886 generally well-conceived and adequate to protect against concerns of a conflict or concentration or competitive nature.

There is one area in which I do have a question—and I emphasize a question—and that relates to whether and with some official blessing it may not be desirable to provide a bit more flexibility in regard to possible avenues for liquidity or financing support for securities affiliates in exigent circumstances.

For example, I wonder if it might not be appropriate to consider an arrangement whereby and with explicit official consent a bank could lend to a securities affiliate in exigent circumstances if such a loan were fully secured by Government or investment grade securities and subject to 23(A) and (B).

As a related matter, a bit more flexibility might be appropriate with regard to the nature of the notice requirements for additional equity injections by a holding company into the securities affiliate.

In each case, I obviously believe that strong safeguards are needed and I also believe that a small element of greater flexibility can be provided in a safe and prudent manner in a way that precludes forcing a solution which ultimately may not be in the public interest.

In short and with those minor qualifications, I am satisfied, indeed quite satisfied, that the combination of the holding company structure and the firewall and related provisions of S. 1886 provides satisfactory and workable safeguards against practices that could be of concern on competitive, conflict of interest, or concentration grounds.

DANGERS IN OUR FINANCIAL SYSTEM AND SUPERVISORY POLICY

Let me now, Mr. Chairman, close with some comments on a broader and indeed I think ultimately more important subject, and that is the whole question of systemic risks in our financial system and supervisory policy.

There are, of course, many reasons why, as a matter of public policy, governments of all kinds and in all places have chosen to subject banking and finance to a higher degree of official supervision than is the case with most other types of business enterprise. Those reasons may include a menu of considerations ranging from investor and depositor protection on the one hand to concerns about misuse of economic and financial power on the other.

However, a more fundamental point lies at the heart of public policy concerns about the banking and financial system. That concern relates to the systemic risks inherent in banking and finance. By systemic risks, of course, I mean the dangers—however small or remote they may be—that failure or instability in one institution or in one segment of the market can quickly be transmitted to other institutions or other segments of the markets, thereby causing a more generalized crisis of confidence with all of its potential for instability in the financial and real sectors of the economy. Concerns about system risk in the financial and banking system are not new. Indeed, Adam Smith, writing in the "Wealth of Nations", made the case for the regulation of banking by equating the responsibility of all governments to regulate banking to the responsibilities of 18th century governments to insist upon the construction of firewalls to protect the many from the problems of the few.

The systemic risk problem in banking and finance is, at the end of the day, what gives rise to the so-called "moral hazard" dilemma associated with banking supervision and regulation. By that, I mean the oft-cited dilemma that public authorities face in responding to problems in the banking and financial sector. The dilemma, as you know, is that if on the one hand the authorities do step in in response to a problem, that action itself entails the obvious danger that it can encourage others to act irresponsibly and recklessly in the belief that they will be "bailed out." On the other hand, if the authorities do nothing, they run the risk that the problem will spread and unleash a chain reaction of other problems and failures resulting in a generalized and far more damaging situation.

Now it seems to me that we have a good grasp on these issues for at least two basic reasons. First, while it is true that the probabilities of an event with major systemic implications occurring are statistically very small, it is also true, at least in my judgment, that the nature of the operational, liquidity and credit interdependencies in our contemporary system is such that the potential—let me emphasize that word—for such a problem should not be dismissed lightly. It is precisely for that reason that I place so much emphasis on what I affectionately call "the plumbing of the system"—payments, clearance and settlement arrangements. These elements of the system are the transmission vehicles through which a problem can spread in a fashion that is rapid and difficult to control, thereby possibly taking on systemic characteristics.

Second, there is a tendency in some circles to associate systemic risk considerations and the so-called "moral hazard" dilemma only with insured deposits or depositories and, at the extreme, only with large insured depositories. In my judgment, that view is simply wrong. In 1985, the failure of a small securities firm in Florida triggered a chain of events that entailed, among other things, the Ohio and Maryland thrift crises and came close to producing a situation that impaired the workings of the market for mortgage-backed securities. That chain of events generated headlines and lead items on the nightly news all over the world. But none of the institutions involved directly were federally insured depositories, and none were large by most definitions. More recently, the developments in October clearly posed systemic risks, but the direct source of the problem was not with insured depositories, although the potential for the problems to affect insured depositories was there.

I raise these considerations at this time, Mr. Chairman, because they are directly relevant, in my view, to the broad thrust of supervisory policy on several counts. One particularly important issue is the question of whether we should insist upon at least a degree of consolidated supervision of the holding companies that own and control a family of financial subsidiaries, especially if one of those offspring is an insured depository. Both S. 1886 and S. 1891 contain provisions calling for varying degrees of such consolidated supervision, which I enthusiastically applaud. But a growing number of influential voices are suggesting that functional supervision alone of the component entities within a financial conglomerate is adequate and, by extension, there is no need for any consolidated supervision of the company as a whole.

I categorically disagree with that view, in part because it can become the smoke screen that would be used to permit a blending of banking and commerce; in part because it can also be used to undercut or eliminate the indispensable role that I believe the central bank must play in the supervisory process. But I disagree most of all because that view collides head-on with the realities of the marketplace. The marketplace views these companies as a whole; the owners of these companies view them as a whole; so it seems to me to follow that an element of supervisory policy must focus on the company as a whole.

The holding companies of which I speak are not mere shells or corporate fictions. They are the financial and managerial nerve centers of the family of enterprises they own and control. They are the entities that raise debt and equity capital in the markets and allocate that capital among the various operating entities. Further, these holding companies raise substantial amounts of short-term working capital in the markets and in their own right are increasingly engaged in on and off balance sheet credit extension activities. Moreover, in the absence of some degree of supervision at the holding company level, the central thrust of supervisory efforts at the level of the operating units can easily be circumvented by shifting activities, as desired, to the holding company level—something we see even now where the holding companies are not supervised.

In all of these circumstances, it seems to me obvious that if the holding company—the entity that is the point of access to the capital markets—has problems, those problems cannot help but have adverse consequences for the operating subsidiaries. Finally, at least in the case of bank holding companies, a move away from consolidated supervision would run directly counter to the grain of international developments and practices. Stated in its most graphic terms, is this the time to even consider a banking and financial system with a large unsupervised financial black hole into which any or all activities can be shifted at the convenience or whim of management in order, among other things, to escape supervisory oversight? Only the Congress can answer that question, as well as the more fundamental question as to the disposition of the banking-commerce debate. For my part, I continue to believe that banking and commerce should be kept separate and that bank and financial holding companies should be subject to a degree of consolidated supervision.

In saying this, I am not suggesting that the holding company needs the same type of supervision that we associate with banks themselves. However, a degree of oversight and inspection authority which focuses mostly on capital, liquidity, and debt service/dividend maintenance considerations at the holding company level strikes me as an indispensable component of any coherent approach to supervisory philosophy and policy.

Whether we care to acknowledge it or not, a multidimensional moral hazard problem is already there. That dilemma can best be solved in an environment in which efforts are aimed at heading off problems before they occur and dealing with them from a position of strength if they occur. The discipline of the marketplace, including the ultimate discipline of failure, will work best when the system as a whole is strong enough to withstand that discipline and when the authorities are confident enough in their ability and capacity to contain the damage from individual failures. In short, what we want and what we need is a supervisory framework that is flexible, yet firm; one that is sensitive to the realities of the marketplace; but, above all, one that helps us to better cope with the moral hazard dilemma associated with the systemic risks inherent in banking and finance. A fail-safe system is neither attainable nor desirable, but one which protects and rewards the efficient and responsible and severely penalizes the reckless and irresponsible is both attainable and necessary.

As I said earlier, the provisions of both S. 1886 and S. 1891 are broadly consistent with these remarks, so I offer these comments not so much in the context of these bills, but rather as a cautionary note for the future. Having said that, allow me to conclude, Mr. Chairman, by stressing that in important respects the future is now. Thus, I would urge this committee, the Senate, and the Congress as a whole to move promptly with at least the enactment of legislation along the lines of S. 1886.

Thank you, Mr. Chairman.

[The complete prepared statement of E. Gerald Corrigan follows:]

For Release on Delivery
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STATEMENT BY

E. GERALD CORRIGAN, PRESIDENT

FEDERAL RESERVE BANK OF NEW YORK

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING,

AND URBAN AFFAIRS

December 10, 1987

I. Introduction

Mr. Chairman, and distinguished members of this Committee, I welcome this opportunity to lend my support to legislation that would modernize the legal framework associated with important segments of our banking and financial system and strengthen its official supervisory apparatus. Specifically, I want to indicate my general support for S.1886 as introduced by Chairman Proxmire and Senator Garn. Legislation along the lines of this bill would constitute one of the most important and progressive federal legislative initiatives in the area of banking and finance that we have seen in many years. It would also be a giant step forward in the direction of the much needed general overhaul of the legislative framework governing the working of the financial system.

In expressing my support for S.1886, I am, of course, mindful of S.1891 introduced by Senators Graham and Wirth. I am sure it will come as a surprise to none when I say I have very considerable sympathy for the broad thrust of S.1891. As I see it, however, the preferred approach would be to push ahead with S.1886 and promptly return to the broader issues posed by S.1891. That approach is made easy by virtue of the fact that the structural approach contemplated in the Proxmire-Garn bill is compatible with the structural approach embodied in the Graham-Wirth Bill. I say this in part because even my own essay contemplated a "building-block" approach phased in over time but also because the Proxmire-Garn bill would, in my view, get us over the most important hurdle standing in the way of a more coherent financial structure -- a giant step indeed!

Consistent with that building-block philosophy, and drawing on the spirit of the 1987 Financial Services Oversight Act, it might be useful to consider, even now, some kind of an instrumentality involving the banking agencies together with the Securities and Exchange Commission and the Commodities Futures Trading Commission. This body might provide a vehicle for initial explorations of what steps should be taken to better rationalize the supervision of activities that cross institutional boundaries, while at the same time more systematically examine the obvious problems of regulatory gaps and overlaps.

II. The Case for Prompt Action

The case for prompt action -- encompassing at least S.1886 -- is compelling. My views of the case for reform were spelled out in detail in my January 1987 essay and reiterated in my testimony before this Committee earlier this year. Nothing that has occurred in the interim -- including market developments in October -- has changed my views in this regard. On the contrary, recent developments have reinforced the case for reform so long as the process of reform is accompanied by appropriate supervisory safeguards -- a condition which has always been in the forefront of my own thinking. Indeed, if there is one overriding lesson to be learned from the events of October, it is that the banking and financial system is just that -- a system. The nature of the operational, liquidity and credit interdependencies that characterize contemporary financial markets and institutions is such that the well-being of any one segment of the system is inexorably related to the well-being of the system as a whole. Because of this our approach to reform and modernization must be guided by some coherent view of the system as a whole, not merely a focus on some of its component parts, as important as they may be.

In the interests of time, I do not want to repeat, in any detail, the specific rationale for prompt legislation. But, as a matter of emphasis, allow me to briefly summarize several key points as I see them:

> *First*, repeal of Glass-Steagall would provide important benefits to consumers and other users of financial services, stemming from greater competition, while at the same time providing greater opportunities for diversification and flexibility for banks and securities firms alike.
>
> *Second*, spurred importantly by technological developments, the operational and balance sheet characteristics of banks and securities firms already have much in common both

domestically and internationally. Both are highly leveraged; both rely importantly on various forms of short-dated liabilities as sources of funding; both compete head-to-head in many product markets here and around the world; and both ultimately depend on public confidence as the lifeblood of their well-being, especially in a context in which market views as to strengths and weaknesses can shift so quickly and abruptly. Finally, both are subject to rapid changes in risk profiles which are difficult for creditors to monitor -- a condition which makes the maintenance of public confidence and the presence of strong supervision all the more important.

Third, the international competitiveness of both U.S. banks and securities companies, as well as the international competitiveness of the U.S. financial system generally, can only suffer in a world in which unnecessary restrictions on the activities of banking and financial institutions are increasingly unique to the U.S. As a senior official at the Bank of England recently observed, "the

> longer Glass-Steagall restrictions are kept in place, the more my own country stands to benefit, as it did from the earlier interest rate controls."

> *Fourth*, under the proposed changes, adequate supervisory tools are available to deal with the problems that might arise from combinations of banks and securities firms. I will have more to say on this subject a bit later.

While the case for legislation, along the lines of S.1886 at a minimum, is compelling, there are, of course, potential drawbacks. As I see it, those drawbacks fall into three major categories. The first is the possibility of an unfair competitive advantage arising from the fact that particular activities performed by one class of institution could, for regulatory or other reasons, be inherently more competitive than like activities of another class of institution. Second is the danger that historic concerns about conflicts and concentration could be swept aside in economically and socially unacceptable ways. Third, there is the risk that individual institutions -- or even worse, the system more generally -- could become more risky and thus more accident-prone.

The CHAIRMAN. Thank you very much, Mr. Corrigan.

Mr. Heimann, go ahead, sir.

STATEMENT OF JOHN G. HEIMANN, VICE CHAIRMAN, MERRILL LYNCH CAPITAL MARKETS, NEW YORK, NY

Mr. HEIMANN. Thank you, Mr. Chairman.

I'd like to have my statement submitted for the record, also.

The CHAIRMAN. Without objection, it will be printed in full in the record.

Mr. HEIMANN. I am honored to have been asked to appear before this committee. I would like to note for the record that the letter of invitation requested me to appear as an individual rather than as a representative of any particular industry group or of my firm, and I do so appear.

Since I've had the opportunity of testifying before this committee on numerous occasions concerning this subject, I shall not consume the members' valuable time with a lengthy restatement. Rather, I would like to confine my remarks to a few basic principles and concepts.

Now regardless of how well our system worked in the post-Depression and post World War II period, the task we face is how we should redefine the roles of the financial intermediaries in order to ensure that the American people receive the best service and products at the lowest possible costs and simultaneously to ensure that well-managed American financial institutions will be able to compete with foreign entities. That's no easy task, to be sure, but one which is certainly not beyond our grasp.

The committee has received reams of testimony outlining a broad array of positions. These proposals have, for the most part, come from special interests, all of whom are attempting to broaden their franchise or protect their turf. In an advocacy system, this is the norm. The exceptions, however, are the comments of the supervisors who are charged to take a broader systemic view and present that which they believe to be in the best interests of the Nation. It is worth noting, therefore, that the financial supervisors—the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission—have all indicated their support for change in Glass-Steagall. In fact, if one discounts those attempting to protect themselves from increased competition, there is an overwhelming consensus for restructuring the financial services industry. The question is how?

BELIEVE WE SHOULD OVERHAUL THE SYSTEM

At the outset, let me state that I am a firm believer in the need for overhauling both Glass-Steagall and the Bank Holding Company Act. This is not the result of a recent conversion. I have so testified to this before this same committee in 1975 and have continuously believed that it was necessary to reshape the American financial system.

I am, however, something of a purist, and perhaps more importantly, an optimist. I believe that the redesign of the American system must be accomplished through a sweeping restructuring. I actually do not believe that incremental change is sufficient. The piecemeal approach, while perhaps satisfying selected special interest groups, does not address the scope or the sweep of the problem.

In sum, I would support S. 1905, noting for the record that my firm is a member of the Financial Services Council, and with some modification, S. 1891. Granted that S. 1886 is a carefully crafted compromise affecting interests within the financial system, it simply, in my opinion, does not go far enough to either represent a truly open and competitive system fair to all present participants, nor does it deal adequately with the problems of foreign competition. Therefore, I do not support S. 1886 and believe that both S. 1905 and S. 1891 provide a far better road map for the future.

Nevertheless, whatever decision is made by this Congress which would result in the continuing integration of commercial banking and the securities industry, I would strongly urge the adoption of some revised form of supervisory oversight. A common theme in all of the bills is the creation of separate affiliates for the newly granted activities which would be supervised, in the first instance, by the existing functional regulator. I agree with this approach as far as it goes. We must build into the system effective oversight of the totality, not just the parts. In this respect, I support the concept of a Financial Services Coordinating Committee which I believe was first proposed by Gerry Corrigan, and supported in testimony before this committee by Federal Reserve Board Chairman Alan Greenspan.

In my experience as a supervisor, many of the problems were the result of those who were inclined to manipulate between supervisory regimes, both domestically and internationally. I realize full well that the existing regulatory apparatus may well oppose this notion, and in fact have so done, since it represents a threat to their agencies' position. Nevertheless, logic dictates that these turf problems be managed so that the security of the system is not prejudiced. Mr. Corrigan and I did not discuss this ahead of time. I would just point out as I did the last time I was before this committee that we use the word "firewall." "Firewall" means that there's a fire or a possibility of a fire, and if there's a possibility of a fire there should be a fireman. It seems to me that's what we need in this case.

Another important issue is the question of economic concentration and that must be dealt with if we want to preserve a highly competitive system. I believe that this can be best accomplished through the antitrust laws rather than through restrictions which can be quickly outdated by the fast pace of events. We have seen all too well in the past 10 years that specific restrictions no longer have the effect for which they were designed since the rapid pace of worldwide deregulation and financial innovation quickly outdates mandated prohibitions. I would prefer leaving such matters to the Justice Department. An acceptable alternative would be to provide the primary regulators with a series of guidelines by which they would administer matters of consolidation.

Finally, none of these bills deals with the matter of deposit insurance, an issue which should be resolved prior to the enactment of any bill. After all, one of the most important considerations with respect to securities powers for commercial banks is the effect that these new activities may have upon the depositor insurance fund. By separating the commercial banks' securities affiliates, these bills attempt to isolate the depositor funds from being affected by securities activities. This concept is valid and is the minimum form of protection we should require.

Nevertheless, these restrictions do not answer the question as to the purpose of depositor insurance. In other words, is depositor protection designed to protect the depositor, protect the bank, protect the banking system, or some combination of these goals? Over time, deposit insurance has met all of these goals. More recently, however, it would appear that the implementation of insurance protection has been, first and foremost, to protect the depositor and then, in limited application, to protect the banking system.

I do not quarrel with this interpretation. Yet it has been implemented by the relevant regulator, the FDIC, as an interpretation of congressional intent. That is understandable since the underlying concepts of depositor insurance have not been meaningfully reviewed by the Congress for many years. Therefore, since the application of deposit insurance and the safety of the insurance system is a fundamental issue around which redesign of the banking system must revolve, I would urge that this matter be focused upon by the committee.

In conclusion, let me agree with President Corrigan, saying that, yes, the future is now, but it seems to be a unique opportunity to seize this moment in time for an overhaul of the financial system which is truly in effect far-reaching, sweeping, and will take us into the 21st century.

Thank you very much.

[The complete prepared statement of John G. Heimann follows:]

In my judgment none of these potential sources of concern are of a nature or a degree that they should stand in the way of legislation. But, the nature of these concerns is such that we should proceed carefully, especially with respect to structural and supervisory considerations. Accordingly, the balance of my remarks will be devoted to these considerations.

III. Corporate Structure and Firewall Considerations

As a general matter, I enthusiastically support the use of the holding company corporate structure approach which is embodied in both S.1886 and S.1891 as the vehicle for achieving greater integration within our financial system. I say that in part because that approach can better facilitate competitive equality, and functional regulation and supervision, but also because it provides an added measure of assurance that abuses can be avoided and problems more easily dealt with if and when they arise. Consistent with that view, I find the specific firewall and related provisions of S.1886 generally well-conceived and adequate to protect against concerns of a conflict or concentration nature.

One area in which I do have a question, however, relates to whether -- perhaps with some official blessing -- it might not be desirable to provide a bit more flexibility in regard to possible avenues for liquidity or financing support for securities affiliates, at least in exigent circumstances.

In raising this question, I am seeking to guard against a situation in which, at the extreme, a securities affiliate is left without liquidity or capital support when otherwise acceptable solutions may be available. Recent experience provides an interesting example of the kind of situation I have in mind. That is, and leaving aside whether the parent was a bank or a securities company, or a holding company of either, would it have been in the public interest (or in the interest of the company as a whole) to have allowed or, even worse, to have forced First Options into bankruptcy during the week of October 19 if alternative solutions acceptable to appropriate supervisors were available? From my perspective and in those admittedly extreme circumstances, neither the public interest nor the interest of the parent company and its bank or other subsidiaries would necessarily be well served by a legislative or regulatory framework that is so rigid that it forces a "solution" that could be highly disruptive even though other more acceptable alternatives might be available. I recognize that this is an extremely delicate and sensitive area but it may be one in which an appropriately limited degree of flexibility could be structured. But I would stress that such arrangements would only be acceptable in a context in which they were accompanied by an appropriate and explicit form of supervisory consent.

For example, it might be appropriate to consider an arrangement whereby -- and with official consent -- a bank could lend to a securities affiliate in exigent circumstances if such a loan were fully secured by government or investment-grade securities and subject to 23-A and 23-B restrictions. As a related matter, a bit more flexibility might be appropriate with regard to the nature of the notice requirements for additional equity injections into a securities affiliate by the holding company. In each case, I obviously believe that safeguards are needed, but I believe a small element of greater flexibility can be provided in a safe and prudent manner.

In summary, and with the qualifications noted above, I am satisfied that the combination of the holding company structure and the firewall and related provisions of S-1886 provide satisfactory and workable safeguards against practices that would be of concern on competitive, conflict of interest, or concentration grounds. I am also satisfied that there is nothing inherent in the riskiness of the securities business that it should stand in the way of the more general changes contemplated by S-1886, so long as both law and regulation require that combinations of banking and securities entities are permitted only in a context of appropriate levels of capital strength and managerial expertise and are associated with an adequate supervisory apparatus.

IV. Systemic Risk and Supervisory Policy

Mr. Chairman, I would now like to close my statement with some comments about the more general subject of systemic risks and supervisory policy.

There are, of course, many reasons why, as a matter of public policy, governments of all kinds and in all places choose to subject banking and finance to a higher degree of official supervision than is the case with most other kinds of business enterprise. Those reasons may include a menu of considerations ranging from investor and depositor protection on the one hand to concerns about misuse of economic and financial power on the other.

However, a more fundamental point lies at the heart of public policy concerns about the banking and financial system. That concern relates to the systemic risks inherent in banking and finance. By systemic risks, of course, I mean the dangers -- however small or remote they may be -- that failure or instability in one institution or in one segment of the financial markets can quickly be transmitted to other institutions or segments of the markets, thereby causing a more generalized crisis of confidence with all of its potential for instability in the financial and real sectors of the economy. Concerns about systemic risk are not new. Indeed, Adam Smith, in the Wealth of Nations, made the case for the regulation of banking by equating the responsibility of governments to regulate banking to the responsibilities of 18th century governments to insist on the construction of firewalls to protect the many from the problems of the few.

The systemic risk problem in banking and finance is, at the end of the day, what gives rise to the so-called "moral hazard" dilemma associated with supervision and regulation. B that, I mean the oft-cited dilemma public authorities face in responding to problems in the banking and financial sector. The dilemma, as you know, is that if on the one hand the authorities step in to respond to a problem, that action entails the obvious danger that it can encourage others to act irresponsibly and recklessly in the belief that they will be "bailed out". On the other hand, if the authorities do nothing, they run the risk that the problem will spread and unleash a chain reaction of other problems and failures resulting in a generalized and far more damaging situation.

It seems to me important that we have a good grasp of the issues involved with respect to systemic risk considerations for at least two reasons.

First, while it is true that the probabilities of an event with major systemic implications occurring are statistically very small, it is also true, at least in my judgment, that the nature of the operational, liquidity and credit interdependencies in our contemporary financial markets and institutions is such that the *potential* for such a problem should not be dismissed lightly. It is for precisely that reason that I place so much emphasis on what I affectionately call "the plumbing of the system" -- payments, clearance and settlement arrangements. These elements of the system are the transmission vehicles through which problems are likely to spread in a fashion that is rapid and difficult to control, thereby possibly taking on systemic characteristics.

Second, there is a tendency in some circles to associate systemic risk considerations and the so-called "moral hazard" dilemma only to insured deposits or depositories and, at the extreme, only with large insured depositories. In my judgment, that view is simply wrong. In 1985, the failure of a small securities firm in Florida triggered a chain of events that entailed, among other things, the Ohio and Maryland thrift crises and came close to producing a situation that impaired the workings of the market for mortgage- backed securities. That chain of events generated headlines and lead items on the nightly news all over the world. But none of the institutions directly involved were federally insured depositories, and

> none were large by most definitions. More recently, the developments in October clearly posed systemic risks but the direct source of the problem was not with insured depositories, although the potential for the problems to affect insured depositories was clearly there.

I raise these considerations at this time because they are, in my judgment, directly relevant to the broad thrust of supervisory policy on several counts. One particularly important issue is the question of whether we should insist on at least a degree of consolidated supervision of the holding companies that own and control a family of financial subsidiaries, especially if one of those offspring is an insured depository. Both S.1886 and S.1891 contain provisions calling for varying degrees of such consolidated supervision, which I enthusiastically applaud. But a growing number of influential voices are suggesting that functional supervision of the component entities within such a financial conglomerate is adequate and, by extension, that there is no need for any consolidated supervision of the company as a whole.

I categorically disagree with this view, in part because it can become the smoke screen that would be used to permit a blending of banking and commerce; in part because it can also be used to undercut or eliminate the indispensable role that the central bank should play in the supervisory arena. But, I disagree most of all because that view collides head-on with the realities of the marketplace. The marketplace views these companies as a whole; the owners of these companies view them as a whole; so it seems to me to follow that an element of supervisory policy must focus on the company as a whole.

The holding companies of which I speak are not mere shells or corporate fictions. They are the financial and managerial nerve centers of the family of enterprises they own and control. They are the entities that raise debt and equity capital in the markets and allocate that capital among the various operating entities. Further, these holding companies raise sizeable sums of short-term working capital in the markets and allocate the proceeds to the operating entities and, in their own right, they are increasingly engaged in on- and off-balance sheet credit extension activities. Moreover, in the absence of some degree of supervision at the holding company level, the central thrust of supervisory efforts at the level of the operating units can easily be circumvented by shifting activities, as desired, to the holding company level -- something we see even now where holding companies are not supervised.

In all of these circumstances it seems to me obvious that, if the holding company -- the entity that is the point of access to capital markets -- has problems, those problems cannot help but have adverse consequences for its operating subsidiaries. Finally, at least in the case of bank holding companies, a move away from consolidated supervision would run directly counter to the grain of international developments and practices. Stated in its most graphic terms, is this the time to even consider a banking and financial system with a large unsupervised financial black hole into which any or all activities can be shifted at the convenience or whim of management in order, among other things, to escape supervisory oversight? Only the Congress can answer that question, as well as the more fundamental questions related to the banking commerce debate. For my part, I continue to believe that banking and commerce should be kept separate and that bank and financial holding companies should be subject to a degree of consolidated supervision.

In saying this, I am not suggesting that the holding company needs the same type or degree of supervision that we, for example, associate with banks. However, a degree of oversight and inspection authority which focuses mostly on capital, liquidity, and debt service/dividend maintenance considerations at the holding company level strikes me as an indispensable component of any coherent approach to supervisory philosophy and policy, especially in a context in which our primary concern should be the stability of the system as a whole.

Whether we care to acknowledge it or not, a multi-dimensional moral hazard dilemma is already there. That dilemma can best be solved in an environment in which efforts are aimed at heading off problems before they occur and dealing with problems from a position of strength when they do occur. The discipline of the marketplace -- including the ultimate discipline of failure -- will work best when the system as a whole is strong enough to withstand that discipline and when the authorities are confident enough in their capacity to contain the damage from individual failures. In short, what we want and what we need is a supervisory framework that is flexible, yet firm; one that is sensitive to the realities of the marketplace; but, above all, one that helps us to better cope with the moral-hazard dilemma posed by the systemic risks inherent in banking and finance. A fail-safe system is neither attainable nor desirable but one which protects and rewards the efficient and responsible and severely penalizes the reckless and irresponsible is both attainable and necessary.

As I said earlier, the provisions of both S.1886 and S.1891 are broadly consistent with these remarks, so I offer these comments not so much in the context of these bills, but rather as a cautionary note for the future. Having said that, allow me to conclude by stressing that, in important respects, the future is now. Thus, I would urge this Committee, the Senate, and the Congress as a whole to move promptly with, at the least, the enactment of legislation along the lines of S.1886.

Thank you, Mr. Chairman.

The **Chairman**. Thank both you, gentlemen, very much for two excellent statements.

Mr. Corrigan, S. 1891, introduced by Senators Wirth and Graham, is explained as being a statutory codification of the framework for expanding competition in the financial services industry that you set forth in your article "Financial Market Structure—A Longer View."

PROPOSED COMMISSION WOULD HAVE BROAD POWERS

S. 1891 has been criticized because it would create a Financial Services Oversight Commission which would have very broad powers to determine the types of activities in which banks and other financial institutions could engage. Critics contend that this broad delegation would remove from Congress the authority to determine whether banks should have broad securities, real estate, and insurance powers.

In your original proposal, did you envision such a broad delegation of congressional authority to a financial services oversight commission?

Mr. **Corrigan**. In fact, Mr. Chairman, that is one area where I do have a little problem with the bill as drafted. It seems to me that it does delegate too much in that regard to that oversight body.

For example, as you mentioned, there are two areas that immediately surface. One is insurance and the other is real estate. It does seem to me, within the context of your own bill, that if you were going to go further, that the Congress, in my judgment, has the first responsibility to at least make initial definitions.

I do think that within the framework of some congressional guidance, there would be a need for some kind of an ongoing body to make sure that particular activities are consistent with broad guidance. We see that, for example, right now in the Bank Holding Company Act all the time. There is statutory guidance, but on a week-to-week, sometimes a day-to-day basis, interpretations have to be made as to whether particular activities coincide with congressional intent. So I think that role is going to have to be filled, but in the first instance, I am of the view that congressional guidance is needed.

The **Chairman**. Mr. Heimann, when Under Secretary Gould testified before this committee on December 2, he said that S. 1886 is worthy of strong bipartisan support and is the appropriate first step for Congress to take in financial restructuring.

On the other hand, you oppose the incremental approach to reform set forth in S. 1886 because it does not address the whole problem at once.

Now if you were convinced that S. 1886 could be enacted in this Congress and that any broader reform could not, would you support the enactment of S. 1886 as a first step to broader restructuring?

Mr. **Heimann**. Mr. Chairman, I'd have to be convinced that a broader reform could not be enacted, and I am not convinced of that yet. I think a year ago if we had come to this committee to have had anything as far-reaching as S. 1886, not to mention the other bills, would have been almost unthinkable. At this time last year the committee was considering very limited powers and some other restrictions.

What is exciting and makes me so optimistic that a further or more far-reaching reform could be done has been the change that has taken place in the thinking of the committee and of the members. That, to me, is exciting and is an indication that we ought to try to go further.

If in fact going further was impossible because it does not meet the majority of the members' views on the subject, then I would support personally S. 1886.

The CHAIRMAN. Well, I appreciate that. As you know, we have the committee. We have the Senate as a whole. We have the House committees, more than one. And we have the House as a whole. We have the conference. We have a long record which Senator Garn has tried very hard and I've tried to help him get legislation through when he was chairman of the committee. And it's a long, hard, tough process.

It seems to me that it's going to be very difficult to get S. 1886 through, very hard, and to go much farther than that it seems to me is going to make it very difficult. But I appreciate your answer.

Mr. Corrigan, in your prepared testimony you don't make any specific comments on S. 1905, The Depository Institution Affiliation Act introduced by Senators D'Amato and Cranston. In introducing that bill, Senator D'Amato said it permits any type of business to engage in any type of financial services activity through the creation of a depository institution holding company, provided that the holding company and its affiliates comply with the additional statutory safeguards required by the act.

Now if you're not prepared to make a specific comment on that bill at this time, could you explain to us whether you believe banking and commerce should be kept separate and why?

Mr. CORRIGAN. As indicated in my statement, Mr. Chairman, as I think you know, I have rather strong views on that subject. I do not think banking and commerce should be combined. I feel very strongly about that.

I sometimes have the feeling on that particular issue that the whole world is a tuxedo and I'm a brown shoe, but so be it. I intend to go on being a brown shoe.

In respect to S. 1905, I obviously have that threshold problem, that it would permit a generalized blending of banking and commerce. I have some other general misgivings about the bill as well. For example, it, too, contemplates a board but it would in that case be a board that doesn't strike me to have the same characteristics of independence as the board contemplated in the Wirth-Graham bill. And I also have some at least a question in my mind as to whether the provisions of the Change in Banking Control Act would be adequate even if the Congress decided to bridge the banking-commerce question.

But my threshold problem is that I view—obviously, it doesn't provide for the kind of consolidated supervision that I think is so important, too.

Because of all those things, it seems to me that the logical extension of S. 1905 is that you should get rid of the safety net altogether. If you've got S. 1905, then I think the logic is forget about deposit insurance, forget about supervision at all, and just let the chips fall where they may. That I think is the logical extension of it.

The CHAIRMAN. I think your brown shoes look great.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Heimann, you state that the Proxmire-Garn bill does not deal adequately with foreign competition. Would you explain why?

FOREIGN COMPETITION

Mr. HEIMANN. Yes, Senator. As I said before, I simply don't think it goes far enough. I mean that's a generality that I truly believe. That is, we have a chance to restructure the financial services industry in a world which is changing very rapidly. Our foreign competition has enormous and different kinds of freedoms with the exception of the Japanese. They are under article 65, which is similar to our Glass-Steagall Act, and which I believe will be changed if the Congress decides to change Glass-Steagall, to permit the Japanese financial banks to compete more effectively.

It seems to me that we need to look at the realities of what the financial system is all about and attempt as best as we can to create an intermediary system in this country that can compete as effectively as possible while protecting the interest of the financial system in this country.

Securities powers are but a part, in my view, of the totality. I come back to the issues that have to be dealt with such as deposit insurance. Because we have deposit insurance, our foreign competitors have limited forms of deposit insurance. All of these bills have elements that could be worked together, but none of them is absolutely perfect. That's the reason I keep hoping that we can stretch out beyond S. 1886 in some of these areas.

One of the factors in terms of foreign competition that was brought up by the Chairman of the FDIC is just simply in terms of who can buy whom domestically, and which has not dealt adequately with the possibility of foreign financial institutions coming into our markets to purchase either banks or securities houses. I'm sure that that can be managed and handled, but that's symptomatic of the kind of problem I see.

This has been said before. What we're trying to do is we have a global marketplace, populated by global financial institutions that are regulated by national standards, national regulatory practices, national accounting standards, and create true and open competition, which I very much believe in, and protections built in on a series of levels for the consumer, the system as a whole and the like. I just feel that more attention has to be paid to those kind of things.

Senator GARN. I think you're undoubtedly aware that my opinions over the years would be that I would support a broader bill as well. I'm sure Chairman Proxmire would. But we are both experts on what the House of Representatives will not do.

The most recent example is the 89-to-5 vote in the Senate in 1984. I remember the comment that Congressman St Germain said to me, he said, "You don't have a consensus on these issues," and I apologized for not getting the other five votes. But, nevertheless, he wouldn't go to conference.

I think that the chairman points out the reality of the situation and no matter what our desires are and preferring to go broader, it's probably not possible. I would like to be proven wrong.

Is one of your problems—and I don't mean just to pick on you but to make a point about the bill—that Merrill Lynch couldn't buy a bank under the Proxmire-Garn bill but could under the Cranston-D'Amato bill?

Mr. HEIMANN. Well, as you know, I'm not here representing Merrill Lynch.

Senator GARN. I understand. That's why I said I don't mean to pick on you but it illustrates a point that some firms under our bill would not be allowed to buy a bank.

Mr. HEIMANN. Well, we already have a bank, Senator.

Senator GARN. Well, you just made the point that I made yesterday; 9 out of the 10 firms do own a bank.

Mr. HEIMANN. We have a bank. I think that we ought to sort of look behind the titles on these things because we don't want a bank to have a bank. Speaking for Merrill Lynch in this case, we've testified to this effect. We don't want a bank to collect insured deposits. Merrill Lynch has one of the largest deposit or quasi-deposit collection mechanisms in the United States through our cash management account and our ready asset trust fund.

Senator GARN. Do you realize what a good witness you are? You answered the question just the way I hoped you would.

Mr. HEIMANN. Honesty is honesty. What we have always sought were certain powers that were restricted to banks, such as access to the payments system, with which President Corrigan is quite familiar.

Our job at Merrill Lynch is to provide services to our clients at the lowest possible costs. So our theory has never been one of ownership of a bank, but to be able to provide certain services which are restricted to banks and are not the traditional commercial banking activities, i.e. sweeping in deposits that are insured or making commercial loans. That is not the function. It has to do much more with the processing of our system as a whole, access to the payments system and the like.

So my objection is not because of that reason. It really is the philosophical one that I put forth at the beginning, and that is, what an opportunity to try it; and if in fact and indeed the House does not go as far as the Senate does, then some compromise surely is required and will take place. But why not take this time to stretch it out and see how far we can go and then make whatever political compromises for reality, as you or the chairman so aptly put it.

Senator GARN. This decade-long battle has made me believe in the Nebraska type system—a unicameral legislative body. Thank you, Mr. Chairman. [Laughter.]

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you.

BUILDING BLOCK APPROACH

Mr. Corrigan, you talked about the building blocks in the Proxmire-Garn bill and this would be a big first step. Of course, then you talk about sweeping changes for the whole financial industry. And you mentioned too, as a lot of us know and you experience every day, the total interdependency between the financial institutions, that one is not standing alone. They are all related. If one is going to do well, the others could do well or should do well.

Now it's probably not politically feasible—I don't know if it's feasible to do the first building block, but I think that it's time because of changed circumstances and so forth for us to make public policy here in the Senate and if we're going to have sweeping changes and if politically we can't do it all at once, we should do it in a logical progression of blocks. It seems to me that the first big step, if we can get there, would be to give the commercial banks certain securities powers and also give the securities people some opportunities—some already have banks, some don't, but most of the big ones do.

Am I reading your testimony right in that regard?

Mr. CORRIGAN. That is essentially correct, Senator. Let me just emphasize that while I obviously have a great deal of sympathy with what Mr. Heimann said and what others have said, the fact of the matter is that the points of greatest tension in this system as we see it right now are in fact banking and securities. And that is where the greatest problem is. Indeed, apropos of Senator Garn's earlier question, when we look at foreign systems, for example, it is clearly true that the dominant characteristic of the foreign systems is that banking and securities are combined one way or another. But it is not true, for example, that banking and securities and insurance are combined. There are cases where that's true, but that's certainly not the general norm.

I think that when we look at it in that light, I certainly do feel that we could eliminate the greatest single point of tension with Proxmire-Garn. But even there, I certainly would not want to leave you or anybody else with the impression that I think we can then go on vacation.

Senator SHELBY. When you talk about a building block, you mean blocks, one block at a time; is that right?

Mr. CORRIGAN. Well, that's one way to do it. I've often pondered—and I want to emphasize the word pondered here—I've often pondered the question in the current debate. I recall, for example, Chairman Proxmire, very well the rather ingenious creation of the 1980 act, the Depository Institutions Deregulation Committee, that created a mechanism to keep the ball in play, so to speak, once some initial decisions were made by the Congress. And I wonder to myself at times whether there might not be something to be said for thinking in those terms, subject of course to some kind of a congressional veto or oversight or whatever.

In other words, there are I think several mechanisms that could be brought to bear and I would support efforts along those lines. But, again, I don't want to downplay the enormous importance that I would associate with getting the securities-banking thing cleaned up. I think that is highly significant.

Senator SHELBY. What about the firewall that you keep talking about? I think that is a central issue here, too, that there be some protection, and who's going to be able to do that.

Mr. CORRIGAN. Well, again, within that framework, I think, as I said in my testimony, the general provisions of the Proxmire-Garn bill and the Wirth-Graham bill seem to me to be in the right directions. But it is also true that there are some incredibly thorny issues that have to be worked out on the supervisory side.

For example, the Chairman of the SEC makes the point—and I think with some obvious justification—that securities activities within banking organizations, regardless of where they happen to be housed, have to in some sense be subject to the same investor protection rules that apply to a securities house of a plain vanilla type. That's easy to say, but in practice it's not going to be too easy to work out.

You have the whole question of, say, interest rate swaps and currency swaps. This is a market where the banks and the securities firms compete head-to-head. In the case of the banks, they will be subject to explicit capital charges. In the case of securities firms, those activities are pretty much conducted at the holding company level, so they are completely out from underneath the capital requirements of the SEC. Now that doesn't mean they are not well capitalized, but my point is that the mechanics of putting it together I think are a bit more formidable than perhaps is often suggested.

Senator SHELBY. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I wish Senator Garn were here because he might have a somewhat different reading of history, but my sense is that in the savings and loan industry the response of Congress and the States to an analysis that they were faced with a shrinking pool of potentially profitable activities was to substantially increase their authority, period; that one of the consequences of that has been to induce into the industry people who saw the safety net of Federal deposit insurance and were able to fly high with various commercial investments and schemes, particularly in real estate, and that we now face a littered circus floor of bodies.

I am concerned that if we follow what appears to be the same path with commercial banks, responding to their increased competitive pressure against their restricted range of activities solely by expanding powers, that we might anticipate the same history repeating itself.

Two questions. One, are you concerned about that potential scenario; and two, if so, what do you believe, in addition to the extension of Glass-Steagall, we should do such as increasing the capacity of regulators to avoid a repetition of that scenario?

Mr. CORRIGAN. Taking the first part of your question, Senator, I think you've done this implicitly but let me make it explicit. When we speak of the thrift industry I think we have two sets of problems. One was the regulation Q problem, the interest spread squeeze problem. That, of course, affected the industry as a whole and most of the firms that were experiencing that problem and that problem alone have made a very substantial and significant recovery from the problem. So that we do have, as you know, many, many thrifts, including some very large ones, that are doing just fine.

The other set of problems in the thrift industry I think are the ones that your question was directed to, where there is at least a suggestion in some circles that the problem in the first instance gave rise to a kind of go-for-broke mentality at the management level which in turn, again it is suggested, has severely aggravated the problem and perhaps introduced elements of abuse that are obviously very troubling. And it is precisely for those reasons that I take the position I do with regard to carefully crafting the types of activities that depositories can engage in and who can own and control those depositories.

Senator Proxmire or Senator Garn earlier mentioned this whole question of real estate within the context of S. 1905. I should say right up front that real estate activities, in my judgment, are a class of activities that would require particular scrutiny from a supervisory point of view, and I myself, despite the great popularity of this even in political circles, have yet to be convinced that we want to do that.

If you go back, as you've done many times, and you look at my essay, there is a glaring omission from it. The word real estate never appears.

Senator **GRAHAM**. Let me ask the second part of my question with a little more sharpness. I am concerned that if the only response we have to what I believe is a demonstrable financial and economic problem with commercial banks—that is, that they are a shrinking share of their traditional market, in large part because of the emergence of new and less regulated competitors—if the only response we have is to allow them to engage in new activities, activities currently prohibited to them, that we run the risk of repeating what's happened in the thrift industry.

So my question is, Is there anything else that we should do beyond what is proposed in S. 1886 in order to give us some confidence that that won't happen?

Mr. **CORRIGAN**. Well, the other major area that has to be thought about, in my judgment, is the insurance field, a major broad functional area. But even there, we have to recognize that the insurance business itself is quite diverse. But that would be the other obvious major financial area to be thought about.

Senator **GRAHAM**. I mean, the regulatory agencies in the thrift industry proved themselves incapable of effectively regulating the new powers which had just been granted. Do you feel that the bank regulators are capable—that's both a quantitative and qualitative capability—to deal with the new powers that this would make available?

Mr. **CORRIGAN**. I'm sorry. I misunderstood you. First of all, let me say this, that as we talk of supervision or regulation—call it what you will—we have to recognize that there is no system of supervision that can be fail-safe nor should it be fail-safe. It seems to me that what we have to recognize is that supervision in a practical sense constitutes, if I can put it in the vernacular, something of the process of throwing some sand into the wheels, but it cannot take account of every conceivable set of contingencies and it shouldn't.

The complexity of the system, as we know it now, is rather astonishing. For example, if you look at the typical large securities holding company today or the typical large bank holding company today, those corporate structures involve organizations that have dozens, dozens of operating subsidiaries and indeed in some cases the numbers run into the hundreds. Now to think that a group of bank examiners, however talented they may be, can fully understand everything that's going on in one of these things is I think misplaced. But can they play a constructive role like some sands in the wheels, flashing the amber lights, or worse if necessary? Absolutely, yes, they can.

But we've got, as I said in my testimony, to be realistic and particularly make sure that that supervisory effort is broad-based. In other words, that it is looking at things on a consolidated basis as well as on a component part basis.

So my answer in a nutshell, are we up to the task, yes. Can the process be enhanced? Yes, with some of the things you've talked about. Can it be fail-safe? No.

Mr. **Heimann**. May I just add something. I agree with Jerry Corrigan. I think you have to be very realistic about it. If you assume that American banks will be granted a host of new powers with which they range from familiar to unfamiliar—because this is not going to be restricted to specific banks, it will be fairly broadspread giving the banks equal opportunity—I think that one has to expect that in a system as large as ours that some of the managers of a few of the institutions are going to use these powers badly. And I don't think there is anything that the supervisors can do about that before the fact. I think that's just a given. If you want an open, free and competitive system, that's bound to happen, Senator.

So the question really comes down to: If you accept that as the given, and you have to, then is the supervisory network able to keep up with all of these developments?

If you have functional regulation, as it's been proposed under these bills, the answer is, yes, because the functional regulators do in fact understand the fields in which they perambulate and should be able to control it to some degree or modify the accidents, some of which are bound to occur. And that leaves open the final question, the one that Jerry Corrigan just addressed, and that is how do you tie it all together? In other words, with the holding company what mechanism is there to prevent manipulation between jurisdictions, assuming the functional regulators are doing the job the way they know how and have proven to be able to do so over a long period of time?

Senator **Graham**. Thank you, Mr. Chairman.

The **Chairman**. Senator Wirth.

Senator **Wirth**. Thank you very much, Mr. Chairman.

Mr. Corrigan, thank you for being here. I understand the potential institutional ambiguity with which you live, having put out one proposal and having Mr. Greenspan come in with another, but we deal with that kind of ambiguity here and I would hope that we are all understanding.

RATIONALIZING THE SYSTEM

Mr. Heimann, I really appreciate your being down here. You and I have been discussing this for a long, long time—this set of issues. You remember that some years ago we talked about the opportunities that were faced 4 or 5 years ago to start looking at rationalizing the system. As I remember, some of the discussions that we had at that point which resulted in my proposal of a commission which you remember came out of the CFTC-SEC accord, the famous Shad-Johnson accord, and a lot of us were saying:

> Hey, how does one part deal with another? How does the Fed deal with the Comptroller of the Currency? How do we look clearly at what goes on in Chicago versus what goes on in New York, if we can draw geographic boundaries?

And there weren't any answers to that and, therefore, the commission idea, which you remember got shot down by Secretary Regan in particular, and the so-called Bush Commission which ended up as a kind of lowest common denominator approach to some very small powers. You remember all of that and, therefore, the opportunity that we had 3 or 4 years ago then of doing some greater rationalization died.

It seems to me we've got another one and maybe the last one, and that's why I found the proposal that Mr. Corrigan had put forth so compelling. It seems to be consistent with opportunities we've had in the past.

I was struck the day before yesterday by Mr. Silver, from I think the Investment Company Institute, who was here and he spoke about the merger of products and providers. That's a quote from him, "the merger of products and providers," that that's happening and there's an inevitability to that, and what we have to do is to deal with that reality. We can't turn back the clock, as I understand what he was effectively saying. We have that as a reality. I would suspect that's reflected in where the business is today, that a very large and growing part of the investment business, the financial services business, is dealing with Government securities and anybody can do that. You can do it at Merrill Lynch or Citibank can do it or a variety of others can do it. Then we look at various mortgage securities and various other backed securities, anybody can get into those as well. Those are burgeoning parts of the business where the overlap is very real, isn't it, between banking and the securities business? And a declining area would appear to be the historic businesses that many of the investment bankers have been in. The municipal bond business I understand is in a decline. Maybe that's temporary, maybe not. The commission business is in a decline compared to where the other markets are.

So I would think that the merger of services and products is real and where people are making their money—where the markets are, where the businesses are going suggest a merger.

Therefore, we come back it seems to me, looking at the history of this, we come back again looking at where the mergers are occurring de facto, and we come back at where the markets are to say that we have got to figure out a way not to turn back the clock but how are we going to put this together and make some kind of sense out of it?

Now to do so, I have stated on a number of occasions that I am increasingly frustrated with just the powers argument, that the problem gets solved—and I think Senator Graham pointed that out in questions that he was asking earlier about the S&L's. We didn't solve the S&L problem by increasing the powers. We really ducked the issue of what we wanted S&L's to be in, how were they going to relate to other financial institutions. We ducked it.

And I hope that we don't do that again in this but rather step back to attempt to look at the basic goals that I suspect we all share and they are laid out very clearly in Mr. Corrigan's opening comments and in the beginning of your proposal where you're talking about safety and soundness and arm's length and all of the goals that I think everybody shares.

Now you say, Mr. Corrigan, that no supervision can be fail-safe, we can't account for every contingency. I think we all agree with that. We want to figure out—again going back to your proposal, which I think you're effectively saying makes sense at some level of coordination—we want to figure out, to use your words, chart the future and do it in a broad-based way to look at things on a consolidated basis.

So we're right back to that again. I understand you have to make certain nods to the powers approach that Mr. Greenspan has done and I think some of that is valid, but let's try to keep our eye if we can also on something of the long-term ball.

You said in your statement as well, Mr. Corrigan, that we have to maintain a separation of financial institutions and commerce, that that is absolutely essential.

If we don't adopt a broader regulatory approach, how do we go about doing that in a day and age of GMAC's, of GE's, of Sears, or a whole variety of commercial ventures who are moving into the area of financial services? The separation is not there. If we don't have a super or a broader regulatory framework, how in the world can we maintain that separation and how, in turn, can we assure that commercial ventures aren't moving into Government-insured ventures and the mix is going to be potentially very damaging?

Mr. CORRIGAN. Well, first of all, Senator, I don't think it's necessary to prevent, say, General Electric from having some kind of a finance company, or General Motors for that matter. I think what we have to do is be absolutely certain that we do not explicitly or implicitly extend the so-called safety net to them.

So my idea has always been that to the extent a manufacturing company wants to have financial operations, fine, as long as it is unambiguously clear that they are doing it on their own hook and that they do not have any put to the Federal apparatus, whether it's the discount window, insured deposits—the cloak, if not the dagger I might add, of official supervision.

So that is the essence of my attempt to deal with that problem.

Senator WIRTH. And who does that? Who assures that that's the case? You just put in the law and say, "You guys behave and do this."

Mr. CORRIGAN. I think if we had a good, sound, workable series of definitions within the framework of the Bank Holding Company Act, for example, we could do it. I think some of those definitions

Testimony by John G. Heimann
Vice Chairman - Merrill Lynch Capital Markets
Before the Senate Banking Committee
December 10, 1987

My name is John G. Heimann and I am currently associated with Merrill Lynch & Co. as Vice Chairman of Merrill Lynch Capital Markets. I am honored to have been asked to appear before this Committee. The views I express synthesize my experience as a practicing investment banker, a former bank regulator on both the state and national level, and as an active participant on matters pertaining to financial systems of this country and the world.

Since I have had the opportunity of testifying before this Committee on numerous occasions concerning this subject, I shall not consume the members' valuable time with a lengthy re-statement of that which exists in the record. Rather, I will confine myself to commenting upon basic principles.

Today we are living through a period of revolutionary change in the global business of financial services. The blurring of distinctions between commercial and investment banks -- as well as between all financial service businesses -- has been apparent since the mid-1970's. The Glass-Steagall Maginot Line, once impregnable, now appears but an inadequate obstacle for those determined to occupy heretofore forbidden territory. And this reality is compounded by the effects of foreign competitors who, with the exception of the Japanese, are not inhibited by Glass-Steagall type restrictions. Regardless of how well our system worked in the post-depression and post-World War II period, the task we face is how we should re-define the roles of the financial intermediaries in order to insure that the American people receive the best service and products and the lowest possible costs and, simultaneously, insure that well-managed American financial institutions will be able to compete with foreign entities. No easy task, to be sure, but one which is not beyond our grasp.

This Committee has received reams of testimony outlining a broad array of positions. These proposals have, for the most part, come from special intérests, all of whom are attempting to broaden their franchise or protect their turf. In an advocacy system, this is the norm. The exceptions are the comments of the supervisors who are charged to take a broader systemic view and present that which they believe to be in the best interests of the nation. It is worth noting, therefore, that the financial supervisors -- the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission have all indicated their support for change in Glass-Steagall. In fact, if one discounts those attempting to protect themselves from increased competition, there is an overwhelming consenses for restructuring the financial services industry. The question is how?

At the outset, let me state that I am a firm believer in the need for overhauling both Glass-Steagall and the Bank Holding Company Act. This is not the result of recent conversion. I have so testified before this Committee in 1975 and have continuously believed that it was necessary to reshape the American financial system. My view is based upon the realities which effect all capital market activities, here and abroad, importantly including the effects of technology, the institutionalization of savings, the uncertainties of markets buffeted by substantial and increasing volatility and by the process of financial deregulation which has been sweeping the globe.

I am a purist, however. I believe that the redesign of the American system must be accomplished through a sweeping restructuring. I do not believe that incremental change is sufficient. The piece-meal approach, while possibly satisfying selected special interest groups, does not address the scope or the sweep of the problem.

In sum, I would support S.1905, noting for the record that my firm is a member of the Financial Services Council, and with some modification, S.1891. Granted that S.1886 is a carefully crafted compromise affecting interests within the financial system, it simply does not go far enough to either (1) represent a truly open and competitive system fair to all present participants and (2) nor does it deal adequately with the problems of foreign competition. Therefore, I do not support S.1886 and believe that both S.1905 and S.1891 provide a better road map for the future.

Nevertheless, whatever decision is made by the Congress which would result in the continuing integration of commercial banking and the securities industry, I would strongly urge the adoption of some revised form of supervisory oversight. A common theme in all of the bills is the creation of separate affiliates for the newly-granted activities which would be supervised, in the first instance, by the existing functional regulator. I agree with this approach as far as it goes. But I do not think that it is enough to insure the safety and soundness of the system as a whole. We must build into the system effective oversight of the totality, not just the parts. In this respect, I support the concept of a Financial Services Coordinating Committee first proposed by the New York Federal Reserve Bank President, E. Gerald Corrigan, and supported in testimony before this Committee by Federal Reserve Board Chairman Alan Greenspan.

In my experience as a supervisor, many problems were the result of those who were inclined to manipulate between supervisory regimes, both domestically and internationally. I realize full well that the existing regulatory apparatus may well oppose this notion, and in fact has done so, since it represents a threat to their agency's position. Nevertheless, logic dictates that these turf problems be managed so that the security of the system is not prejudiced.

Economic concentration is another important issue which must be dealt with if we are to preserve a highly competitive system. I believe that this can be best accomplished through the anti-trust laws rather than through restrictions which can be quickly outdated by the fast pace of events. We have seen all too well in the past ten years that specific restrictions no longer have the effect for which they were designed since the rapid pace of worldwide deregulation and financial innovation quickly outdates mandated prohibitions. I would prefer leaving such matters to the Justice Department. An acceptable alternative would be to provide the primary regulators with a series of guidelines by which they would administer matters of consolidation.

Finally, none of these bills deal with the matter of deposit insurance, an issue which should be resolved prior to the enactment of any bill. After all, one of the most important considerations with respect to securities powers for commercial banks is the effect that these new activities may have upon the depositor insurance fund. By separating the commercial banks' securities affiliates, these bills attempt to isolate the depositor funds from being affected by securities activities. This concept is valid and is the minimum form of protection we should require.

Nevertheless, these restrictions do not answer the question as to the purpose of depositor insurance. In other words, is depositor protection designed to protect the depositor, protect the bank, protect the banking system or some combination of these goals? Over time, deposit insurance has met all of these goals. More recently, however, it would appear that the implementation of the insurance protection has been, first and foremost, to protect the depositor and then, in limited application, to protect the banking system.

I do not quarrel with this interpretation. Yet it has been implemented by the relevant regulator, the FDIC, as an interpretation of Congressional intent. This is understandable, since the underlying concepts of depositor insurance have not been meaningfully reviewed by the Congress for many years. Therefore, since the application of deposit insurance and the safety of the insurance system is a fundamental issue around which redesign of the banking system must revolve, I would urge that this matter be focused upon by this Committee.

are outdated and that's the essence of the narrow nonbank bank problem.

But I do think that with some modifications to existing statutes that we can manage that in an acceptable way. But it won't work unless we have also created a framework in which broad-based financial concerns—the Merrill Lynchs of the world included—can on their own compete in the market environment that you so aptly describe.

So if we're going to have as one goal maintaining the separation of banking and commerce, which again I think is extremely important, the complementary role has to be an integrated, viable, competitive, open financial system in which the financial players—be they banks or securities companies or whatever—have the flexibility to be able to compete effectively in domestic and international markets.

So to square the circle, you need both pieces. And that is the essence of my idea.

Senator Wirth. You know, our legislation, built in large part on your proposal, waives Glass-Steagall and then goes to this other approach. So I think we are trying to do both pieces in that.

Thank you. Thank you, Mr. Chairman.

The Chairman. Senator Riegle.

TRADE DEFICIT

Senator Riegle. Thank you, Mr. Chairman. I want to just share a piece of data this morning, because it is the backdrop against which I think this discussion also has to be weighed and measured. The October trade statistics were reported this morning. Our trade deficit was $17.6 billion, the worst ever in our national history. If every month was that bad, that would be an annual level of $211 billion on the trade deficit side, and of course, that comes after the fall in the dollar over a long period of time, more recently, even further.

We have got a serious problem here. The stock market is obviously reacting negatively to that this morning, as one would expect it to. But this whole question of the turmoil in the markets and these very serious trend line problems, the trade deficit, and the Federal budget deficit, which we are working on, on the floor right this minute, it seems to me all provide a very powerful backdrop—which must affect how we draw the boundary lines with respect to financial services in this country, and how we decide the degree to which we want to commingle other financial services and/or commercial activity into the heart of the commercial banking system.

FEDERAL SAFETY NET

I am very concerned about the Federal safety net issue. I am concerned about it with respect to savings and loans, where we have got a lot of anomalies. I am concerned about it with respect to nonbank banks, where we have got this unique situation, where we have Federal deposit insurance pulled into the picture there, I think, without a clear understanding of exactly what the implications of that might be. And in effect, at least some proposals are moving Federal deposit insurance out over and under another block of activities.

I find myself, by nature, on that question very cautious and very careful. I think the banking system has taken a lot of hard blows, there are more coming, in terms of foreign loan problems and other things. So I guess I approach this from the point of view of really needing to see a very powerful body of evidence to convince me that we need to take steps that, in part, start to add risks into the system. We may find that that needs to be done for a variety of reasons, but I want to really understand the size of that risk and the implications of that risk, before we do it.

So I would like to hear both of you talk about how much further out we should take the Federal deposit insurance guarantee, not to mention access to the Fed window, but—as important as that is—how far out do we take it? Do we take it under just things like mortgage-backed securities and revenue bonds and commercial paper and maybe mutual funds, or how far do we go? Do we take it under stock underwriting, corporate underwriting? Is that prudent?

Mr. CORRIGAN. In my view, Senator Riegle, the so-called "firewall" provisions of the Chairman and Senator Garn's bill adequately address that problem and, indeed, say to me that the risks that we are taking, insofar as the extension of deposit insurance, are de minimis. I do think that, again, the holding company structure with the firewall protections that are provided, goes a very long way in dealing with that problem.

But as I indicated in my statement, I also believe that the underlying problem of systemic risks, generalized risks, in the financial system as a whole, is one that far transcends the deposit insurance question in and of itself. As a matter of fact, I think that is one of the rather large myths that many people seem to be operating under, and it is precisely for that reason that I insist, as a further safeguard, we have got to have that element of what I call coordinated and consolidated supervision of these entities as a whole.

So I am not in any way insensitive—I don't think—to the concerns you are raising and, indeed, what I am calling for is a three-tier set of protections—the holding company first, the separate affiliate second, with the firewalls, and the functional supervision, and third, the consolidated supervision.

Senator RIEGLE. Well, these 5 minutes go by very quickly. We have just gone through two insurance fund bailouts, which you are familiar with. One with the FSLIC, and we struggled with that. We just passed the Farm Credit System bailout. I think it can be called that, in some sense. So we are finding that the pressures that are coming down on these insurance systems are very real.

Mr. CORRIGAN. That is right.

Senator RIEGLE. Now I want to pursue it—my time is up, but Mr. Heimann, if you have got a comment you want to add, you ought to be able to do so.

Mr. CORRIGAN. Could I just make one quick comment, John. That is why the independence of the supervisory apparatus is important too.

Mr. **Heimann**. I find myself in exact agreement with Jerry Corrigan. I do believe that you have to have these layers of protection and supervision.

I would like to comment on another remark that you made. I think everyone would agree that we do have a blurring of financial services, and we must have a supervisory system that can deal with this kind of new world, if you will. But what I am concerned about—and I am not here representing the Securities Industry Association—is that the thrust of the discussion is somewhat off the ground, if you will, of market-based reality. Let me put it this way. If you assume that the commercial banks are given a broad array of new powers, and they will use them as they should, then competition in the securities industry will increase dramatically.

I think the committee has to have some concern with respect to the health and the strength of the securities industry, when a vast new number of competitors are thrown at them. Now I am not in favor of all the yuppies, and I have seen the movie, "Wall Street," which is not exactly a description of Wall Street, but it is an interesting one. It is quite fun, actually.

What, in my view, has to be done is to try to make sure that everybody is competitive, which was the point I made in my testimony. It doesn't seem to be good policy to throw into an industry which, by congressional intent, has been fragmented for 50 years, and to say that the world has changed, which it has, and we now toss into the pot vast new numbers of competitors, unless those who are receiving the increased competition are also treated in a way that they can compete equally and fairly with this broad array of competitors.

And I would argue that that is proper and it is good public policy. Who takes what powers and uses them, what members of the securities industry decide to be in banking, I have no idea. That is really not the issue. But to toss it all up in the air, leaving one set of participants stable and the others with a vast new array of powers, somehow seems to me is asking for some trouble out there. But we do know what is going to happen when you have a vast array of the competitors, is that profit margins will be cut. This is invariably what will take place, and that is good, because it serves the public, and it serves the system as a whole. It improves our international competitive base.

I am not arguing about that. But I would argue that it would be better, and I think could make our overall system stronger, in the face of international, as well as domestic competition, that the securities houses be given the same powers in the reverse, squaring the circle, as Jerry Corrigan has said, simultaneous with the granting of substantially new powers to the commercial banking system.

OVERSIGHT BY CENTRAL AUTHORITY

The **Chairman**. Mr. Corrigan, when Henry Kaufman, of Salomon Brothers, testified before this committee on financial restructuring, he said it should be accompanied by the establishment of, first, an official central authority to oversee all major financial institutions and markets, and second, an official international authority to oversee major financial institutions and markets, regardless of their location in international institution.

Do you agree with that recommendation?

Mr. CORRIGAN. I certainly agree with the broad thrust of it at a philosophical level and, indeed, I would observe that as a practical matter, things are already moving in that direction. I can tell you, for example, that the level of informal but, in my judgment, quite effective working relationships among the community of central banks around the major countries of the world, has improved dramatically, and as one concrete manifestation of that, later today, the Federal Reserve and the other banking regulatory agencies in the United States, together with our sister central banks and banking authorities in all of the G10 countries, plus Switzerland, will be announcing an agreement reached at Basel at the BIS this weekend, whereby we are now prepared to move forward with a consistent soup-to-nuts approach to common standards of bank capital adequacy for all eleven countries.

The CHAIRMAN. That includes the Common Market and Japan?

Mr. CORRIGAN. Not all the Common Market, Senator. Some of the smaller countries are not, but it is the G10, including Japan, Canada, the United States, France, Italy, Switzerland, Germany, the United Kingdom, Sweden, and Belgium.

Some of the Scandinavian and Baltic countries that are technically part of the Common Market are not in that agreement.

The CHAIRMAN. A few months ago when Paul Volcker was Chairman of the Federal Reserve Board, he announced something like that with the United Kingdom, as I understand it.

Mr. CORRIGAN. That is correct.

The CHAIRMAN. This is an extension, I take it, of that.

Mr. CORRIGAN. A year ago the United States and the United Kingdom took that step on their own, and I think it is probably fair to say that the fact that the United Kingdom and the United States were willing to do it on their own had something to do with our ability to enlarge the party, but I do think that this is a concrete—and I would submit, dramatic—illustration of the kind of thing that needs to be done and is consistent, I think, with the spirit of Mr. Kaufman's comment.

The CHAIRMAN. Mr. Heimann, would you like to comment on that?

Mr. HEIMANN. Well, first of all, I would just like to say how pleased I am that this agreement has finally taken place. The Fed and the Bank of England deserve a lot of credit for getting it started because there is no question in my mind that in an international market, that you must have common standards. Otherwise you will create, in this world of ours, something I choose to call regulatory arbitrage, in which the participants in the markets seek the area of the least offensive regulations and move their activities to where they have, what we might call the biggest break, with the greatest opportunities on a competitive basis.

I am very much in favor of international harmonization of standards throughout the system, as a whole.

The CHAIRMAN. Apropos of that, can you tell us whether any progress was made in the securities area to try to harmonize capital requirements?

Mr. **Heimann**. To my knowledge, the securities administrators from around the world have started to discuss this subject. But to my knowledge, there has been no concrete progress, in the sense of creating similar capital standards in the securities operations in the various areas of activity, in Japan, the United Kingdom, Germany, and the like. I am not an expert on that, Mr. Chairman, but I don't think very much has happened along those lines, at this point.

I just would finally say that what we have to seek is what has started to have been done and that is harmonization. You cannot homogenize standards because of sovereignty, different customs and different laws. But we can create an international community of financial regulation, that creates the same fundamental standards, but operated differently in each country, depending on their own national prohibitions or tax laws or whatever it happens to be.

We are at the beginning of a major step forward. It is very important.

BANKS AND UNDERWRITING SECURITIES

The **Chairman**. Mr. Corrigan, in your paper entitled, "Are Banks Special?" you suggested that banks should not be permitted to underwrite securities. You have clearly changed your views since that time.

Can you explain what caused you to change your position?

Mr. **Corrigan**. Well, first of all, Mr. Chairman, I think that, as I recall, the last five pages of that 1982 article left open the possibility, but if you ask me what changed the degree of my thinking, it is the marketplace, in a nutshell. You know, if I could—I quoted Adam Smith earlier, if I could take myself back to a nice neat world, where all forms of lending were short-term credits, secured by real bills or real goods, gee, I'd love it, but it is not in the cards. I think that we, as central banks, supervisors and, indeed, you as the Congress, don't have the choice of dealing our own cards to ourselves. We have to take reality and cope with it. So I think what has changed me, in a nutshell, is the marketplace.

The **Chairman**. Senator Graham.

COORDINATING STRUCTURE AMONG FINANCIAL INSTITUTIONS

Senator **Graham**. Thank you, Mr. Chairman. Both you gentlemen have advocated the importance of a coordinating structure among the various forms of financial institutions. Assume that your advice is not heeded and that for the next 5 or 10 years, we do not move to such a coordinating system, what do you think would be the likely consequences of our failure to act?

Mr. **Corrigan**. Well, sir, you have asked that question in a slightly different context earlier. I think the greatest danger is the one that Senator Riegle was referring to in a different way, and that is, rather that the system becomes more unstable, because as I said, the realities of the marketplace are there, and I think another danger that Mr. Heimman has already touched on is that our financial institutions, regardless of what they are called, positioned under the sun in the international arena can only suffer as well. I also think that there is a feature in my essay on financial market structure, or the blue book, as I call it, that I would like to mention too in that regard.

The aspect of traditional plain vanilla commercial banking that is under the greatest competitive pressure is the plain vanilla intermediation process, the process whereby the bank, as we have known it in the past, gathers deposits in the marketplace and takes those deposits to fund loans.

Now, one feature of the banking system that is crucially important and often ignored is what I call its role as the penultimate lender of last resort. In other words, the capacity of the banking system to be able to serve as the backup source of liquidity to the system, as a whole, second only to the central bank itself, and that function has to be performed by somebody, and indeed, if you focus on the events of mid-October, it seems to me, we saw a classic illustration of why that function, as the backup source of liquidity, is so crucial.

So that as we try to structure a new system, let's not, in the process, lose sight of the things about the current system that are important and good. But I think that is the major things that would——

Senator **GRAHAM**. Are you suggesting that the absence of moving forward with a coordinating agency will weaken the capacity of commercial banks to serve that liquidity function?

Mr. **CORRIGAN**. No. What I am saying is that if the commercial banks don't have broad enough competitive flexibility to be able to be effective overall instrumentalities in the marketplace, there is the danger that that function gets swept aside in the process.

Mr. **HEIMANN**. Senator, the way you pose the question, if it is not heeded, what will happen? My answer is, it will be heeded, because it will either be heeded before the fact or after the fact. Now I don't have a crystal ball, and when I say I guarantee there is going to be a problem, I don't know. We haven't even started on this new road, but I guarantee there is going to be a problem.

Senator **GRAHAM**. Let me ask, you say we are going to do it. The question is, do we do it before or after the crisis that forces us to act. What would be the characteristics of that crisis that would be the forcing agent?

Mr. **HEIMANN**. It may not be a crisis, but it will clearly be an outrageous abuse, which may or may not lead to a crisis. The way you control financial crisis is by immediate intervention, if you will, of a supervisory authority in one form or another.

I mean, the key in our financial system is a combination of two words—containment of problems and the discipline of those who brought the problem to bear on the system as a whole. How do you contain it when it happens, then how do you punish or discipline those who have created the problem, as a warning to others not to repeat the performance.

So that I am not sure it needs a crisis, but certainly, an outrageous abuse would be sufficient. I recall the case of Mr. Lance and the abuses that he had and the effect that that had on the Congress at that time, in terms of legislation that was written then.

So that my view on the thing is that knowing it is going to happen, why not create the system by which, when the abuse does come to pass, it is contained, in the first instance, and then the transgressor is disciplined. And I believe we should put that in at the beginning and not wait for something.

The **Chairman**. Senator Wirth.

Senator **Wirth**. Thank you, Mr. Chairman. Just to follow up on that, Mr. Heimann, what is the "it"? You are saying we have to create it before or after a crisis. What, in your opinion, is the "it"?

Mr. **Heimann**. I think, for example, the concepts that have been written into both the Cranston-D'Amato bill, as well as the Wirth-Graham bill, in terms of the oversight committee.

Now there are variations on that theme. I don't think that is strong enough in S. 1905, for example. I would strengthen it considerably from 1905. There must be some kind of oversight, so that you don't get manipulations between regulatory schemes. Now whether you use an existing entity and expand it or create a new commission, and whether that commission has a public representative rather than just the regulators themselves we must have a coordinating committee that has sufficient power to bring problems to the attention of this Congress, if it happens that the agencies themselves do not choose to agree.

Senator **Wirth**. And then the question is how much power to give to such a group as that. And that is the question that was raised by Mr. Corrigan, as well, earlier and a number of people have brought up. So if we do it, then the question is how far to go with such a group like that and what kind of authorities do you give it, and that would seem to me to be perhaps the next set of discussions that we ought to have here, having moved the debate, I have a feeling, beyond power only, that we have all agreed, I gather, that just to redistribute or to expand powers is not adequate to solve Senator Riegle's problem of stabilization. Powers alone doesn't do that; isn't that what both of you are saying?

Mr. **Corrigan**. Right. I agree with that.

Mr. **Heimann**. Yes.

INTERNATIONAL HARMONIZATION

Senator **Wirth**. Let me ask you, as we talk about the harmonization or the Basel agreement, who do we deal with, say, in France or Germany? Is the central bank the authority that you deal with on securities and banking, and so on, or do they have a fragmented authority like we do?

Mr. **Corrigan**. Well, in most of the countries, the problem does not arise, because the systems are more integrated in the first place. In other words, for example, if you take the Central European countries, they have universal banks, so that all of these things take place under the same umbrella in the first place. So they don't have the same degree of problem that we have, to begin with, in terms of their——

Senator **Wirth**. How about the French or the Japanese or the Italians?

Mr. **Corrigan**. The Italians, the central bank has broad-based authority. In Japan, it is split between the Bank of Japan and the Ministry of Finance, and again, Japan's system is a lot like ours, of course, in that they have their own article 65, which is more or less Glass-Steagall. So in some countries, the jurisdiction is split, but in most of the major countries, the problem is far less acute than it is here. The British, for example, are wrestling with this right now. The Bank of England, historically has had very broad-based authority here, but with the Big Bang, they are right now wrestling with the question of how to integrate the Securities Industry Board, which is more or less the equivalent of the SEC, in some sense, with the activities of the Bank of England.

Senator WIRTH. So there is no clear trend, internationally, if we are after harmonization, which I gather you are both suggesting is important for the stability of our markets internationally and for our ability to compete internationally, some greater harmonization is necessary.

Mr. CORRIGAN. Absolutely.

Senator WIRTH. But it is not clear that that harmonization is going to come through broader central authority? It may be other countries will follow the model that we have followed of a lot of diversification, or is the trend toward some kind of broader concentration of authority?

Mr. CORRIGAN. Again, the problems, Senator, are also different to begin with. As I said, in several countries, the European countries, the problem doesn't even arise, because all of this stuff is under one umbrella.

Senator WIRTH. The point is, if there is going to be a harmonization internationally, how do we get into that regime, if we don't have some kind of central capability?

Mr. CORRIGAN. We are in it. By virtue of this agreement, we are in it. And this agreement is binding on the universal banks in countries that have universal banking systems and, indeed, that is one of the morals of it.

Senator WIRTH. As I understand it, we are only in banking and not in securities, and the question is, how do we get into it and then coordinate these measures?

Mr. CORRIGAN. Well, that, I think, is an interesting question. It seems to me that if we have been able to carve out this kind of a broad-based agreement among eleven countries, where the institutional differences, to begin with were so incredibly large, we ought to be able to figure out a way to do it in our own country.

Senator WIRTH. My time has expired again. I thank you both very much for being here. I think this was a very helpful morning. Thank you.

The CHAIRMAN. Senator Riegle.

FIREWALLS

Senator RIEGLE. Mr. Corrigan, if you could build a firewall that really works between commercial banking and investment banking and other financial services, why can't you build an equally effective firewall between that package and commercial business, generally?

Mr. CORRIGAN. If you wanted to subject General Motors to official supervision, you could, but that is precisely the point, that I think that the vital distinction, at least in my approach, is that the consolidated entity in the financial sphere would be subject to a degree of official oversight.

Senator Riegle. Yes, but you don't envision the same overseers monitoring each and every thing that goes on in the commercial bank versus the other financial services. So you are talking about two sets of regulators.

Mr. Corrigan. You would have, in my scheme——

Senator Riegle. Why do you necessarily have to have a set of regulators out in the third unit if you tack it on, if, in fact, you've got a foolproof firewall?

Mr. Corrigan. Well, you see, I don't accept the fact that you can have a foolproof firewall, and it is for precisely that reason that I do not accept the banking and commerce combination and I insist upon the third tier of protection, and as I mentioned before, I want to consolidate it.

Senator Riegle. So you want two sets of watchers, and then you want the super watchers.

Mr. Corrigan. That's right.

Senator Riegle. And even then, you are not sure you've got a firewall that is going to be perfect. I think you made that point.

Mr. Corrigan. No. Then I think you have a system, that I think is competitive, functional, and safe.

Senator Riegle. But I still don't understand why—the reason that you have regulators for the banking part and then the other financial services part, is that those are two areas that we now regulate. There is deposit insurance and the various other things, but in the third part, in the commercial area, we don't, as such, regulate that in the same ways as we do financial services.

So why would you need to concern yourself with regulating that part, if you've got a workable firewall?

Mr. Corrigan. Let me give you an example, Senator, I think maybe is the best way to do it. Suppose, just hypothetically, you have a nice, neat corporate structure. You've got a holding company and two operating units. One is an insured depository, the other is a securities affiliate a la Senator Proxmire's bill. And the holding company is up here by itself. The bank is subject to regular bank regulation. The securities affiliate is subject to regular SEC regulation, and you've got capital standards for both components, functional regulation, the whole nine yards; however, the parent is not supervised at all, whether it happens to be a financial or nonfinancial company, it doesn't matter for these purposes. What matters is the following:

The parent is the entity that has the access to capital markets. The parent is the entity that goes out and raises equity, debt, commercial paper or whatever. The parent then downstreams the proceeds of its capital market fundraising activities to both the bank and the securities affiliate.

Now if the parent is totally unregulated, it can downstream that money any way it wants. For example, it can say it is downstreaming all—it raised all debt in the open market, takes that downstream to the subsidiaries and calls it equity. Each one of those subsidiaries under that scenario would clearly meet the functional supervisor's requirements for capital, but the parent is sitting there with no equity and a whole bunch of debt. And the only way the parent can service that debt is by the dividends that it draws out of those affiliates. Now in those circumstances, if that parent gets into trouble, it is unimaginable to me that that trouble will not be felt by the offspring.

Now the particular practice——

Senator RIEGLE. We are talking about two segments——

Mr. CORRIGAN. Right.

Senator RIEGLE [continuing]. Or three?

Mr. CORRIGAN. Well, there is one parent——

Senator RIEGLE. I understand, but I am saying why—I don't understand how that problem doesn't attach to the approach that you are suggesting, just as much as it does to the other approach.

Mr. CORRIGAN. Because I would supervise the holding company on a consolidated basis, and I would not permit the holding company to double leverage itself to the point——

Senator RIEGLE. But you could do that anyway. I mean, you could devise any kind of a scheme you want. You could have that scheme such as you have set out now with commercial banking, and then other financial services. You could have the umbrella over that. You could make sure you have your firewall between the two. If you attached other commercial activities in the third phase, you could require a separation. You can take and put separations in there that would not permit that to happen. You are presumably going to have separations between the two that you are anticipating putting together.

Mr. CORRIGAN. No, I don't see that, because if the entity that is——

Senator RIEGLE. Well, you could prohibit any capital flow back and forth.

Mr. CORRIGAN. But at that point, then there is no point to permitting the combination to begin with.

Senator RIEGLE. But then it seems to me what you are saying is that you are quite prepared to allow the capital flows to go back and forth under the holding company with the two parts you are now consolidating, and that is the essence of your scheme.

Mr. CORRIGAN. I am not prepared to permit funds from the insured depository to be cross streamed to——

Senator RIEGLE. So it is a one-way street.

Mr. CORRIGAN. The holding company——

Senator RIEGLE. So the financial service company could put money into the bank, but it can't take money out of the bank.

Mr. CORRIGAN. Exactly. And the holding company——

Senator RIEGLE. Am I right on that?

Mr. CORRIGAN [continuing]. Itself.

Senator RIEGLE. Am I just right on that question of capital flow.

Mr. CORRIGAN. Yes.

Senator RIEGLE. The financial services company can't tap the capital of the bank.

Mr. CORRIGAN. Right.

Senator RIEGLE. I have a problem at that point in understanding why it would be that the financial service company would want to take and put its capital—it can't get capital from the bank, but why would it want to give its capital to the bank?

Mr. CORRIGAN. Well, that is the essence of what a holding company is. Again, the——

Senator **Riegle**. No, I understand that. It can do it. I am asking the question, why would it want to do it?

Mr. **Corrigan**. Because the holding company, which is the shareholder for both of these units, believes that the corporate entity, as a whole—in other words, the entity that is selling its shares in the marketplace, its profit potential is greater that way, than it would be the other way.

In other words, the notion is that the overall earnings capacity profitability of the entity as a whole is greater than either of its component parts. And that is a—that is a time-honored——

Senator **Riegle**. So the profits in the capital accumulation can be taken out of the financial affiliate and taken over to beef up the capital of the bank.

Mr. **Corrigan**. Of course.

Senator **Riegle**. I mean, that is the essence of it, but it can't go the other way.

Mr. **Corrigan**. That is correct.

Senator **Riegle**. We could talk a long time about that, but if the whole concept hinges on that purpose or that value, that is very central to it. I think that needs to be looked at under a very bright light for a while.

Mr. **Corrigan**. I don't think it is central, in the sense of that your question just suggested. What is central, in my judgment is trying to get ourselves at a system which provides all we can, in terms of competitive advantages, while at the same time, protects against the kind of abuses that your questions are suggesting.

Senator **Riegle**. My time is up, and I don't want to cut you off, but——

Mr. **Heimann**. Could I just add to that? I think we have to have a discussion on two levels. One is kind of a philosophical level, that works this way. The other is on what really happens amongst people, because in the example we have just used, there is a holding company. There are two affiliates. The holding company is public. It is the main company, obviously. Those who run the affiliates really report to the holding company. But again, I have to come back to something I said in my testimony, that most of the bank manipulation that I have seen has been that the manipulation of sums of money between affiliated institutions, because the management of the company is involved in acts which are not correct. And you cannot control that, unless you look at the whole simultaneously. You simply can't control it.

And therefore, the mechanism has to be the one that Jerry Corrigan and I are talking about, which contains some kind of oversight of the holding company, regardless of what the holding company is.

If the oversight is nothing more than being able to look at the transactions themselves between affiliates or understand whatever orders are passed down from the holding company to the affiliate, it is some way to control them.

The second point I would make is that this banking system of ours or financial system is so broad that we must have a kind of governance, if you will, that will help us to protect the system against the relatively few, but who are there, and are out to manipulate the system.

Senator **Riegle**. I don't question that point, as a matter of fact.

The **Chairman**. Gentlemen, thank you very, very much.

Senator **Riegle**. Wait a minute. If you are going to finish.

The **Chairman**. These gentlemen have been very——

Senator **Riegle**. I would like to do another round, I would like to pursue this a little bit further. I am willing to stay and chair.

The **Chairman**. Well, that's fine. I don't know. Both of these gentlemen are very busy men, have other commitments. You have been very generous with your time. You have been here more than 2 hours. Could you stay a little longer and let Senator Riegle question you further?

Mr. **Heimann**. Sure.

Mr. **Corrigan**. Yes, sir.

Senator **Riegle**. Well, actually, it is the turn of my colleagues.

The **Chairman**. I understand that, but I am going to turn the gavel over to Senator Riegle.

Senator **Riegle**. Thank you. [Laughter.]

Mr. **Corrigan**. You didn't include that in your initial question. [Laughter.]

Senator **Riegle** [presiding]. Senator Graham.

Senator **Graham**. Designated Chairman, I just have one question, which is intended to clarify the questions you were asking, and then as far as I am concerned, I would turn it back to you.

I thought that what you might be getting at was the issue, if we have at tier one, the holding company, and let's assume that we have constructed an appropriate supervisory entity for that. Then at tier 2, we have a series of horizontally equivalent affiliates of the bank holding company, which we have talked about at this point too, a bank and a securities firm.

I thought maybe the question that Senator Riegle was asking, if you had that structure, what would be the public policy reason not to add a third affiliate, which might be a pure commercial enterprise, assuming that you have adequate supervision at the tier one.

Mr. **Corrigan**. Well, my answer to that is that—and I went into this at great length in my testimony here back in June, I think it was—my answer to that is that any way you cut it up, that entails the clear danger, however subtle, that you de facto extend the so-called safety net to the commercial concern. In other words, you compound what I called earlier the systemic risk problem by another very large step.

Again, I would emphasize, and Mr. Heimann can probably speak to this a lot better than I, since he works with it every day, we already have a situation in which the companies of which we speak are incredibly complex. And I just gave this nice neat little example. As I said before, in the real world, we are talking about corporate entities that literally have dozens, hundreds of subsidiaries and affiliates.

Senator **Riegle**. Senator Wirth.

Senator **Wirth**. Thank you, Mr. Chairman. Two, one question, and then a kind of a summary. The question, one of the items that we have been talking about is, who else has a stake in this, other than the banks and the investment banking people, and you know, a few commercial operations and the insurance folk, or who are the users out there that ought to be heard from in this process?

INVESTORS AND CONSUMERS ARE USERS OF THE SYSTEM

Mr. **Heimann**. Well, you've got two sets of primary users. First of all, there are the investors or takers in the system. The consumers are people who use the system to process their day-to-day financial activities and save money through the system. And that is the consumer. I mean, in the broad sense of the word, it is the consumers, and their interests, of course are obviously a safe, sound protection of their deposits, a system that facilitates their transactions at the lowest possible cost and also protects them from other kinds of abuses, such as investor protection.

That is one group of users in the system.

The other important group of users in the system are those who raise money, issue securities through the system or borrow money from the system, which also includes individuals borrowing for mortgages, for example, as well as governments or corporations who need to raise money to build their businesses, finance their inventory or whatever other reason.

Now it is the entire American public, both corporate and individual in a variety of different ways who are the users.

Senator **Wirth**. Senator Riegle, if I might get your attention for a second, the question of the users, who uses this, when we redid all of the communications area, we had a classic battle between the cable people and the broadcasters and the telephone and all of the providers. We made a yeoman effort to get users to come in and tell us what the stakes were and what their concerns were, and that was impossible. And they just couldn't get over that threshold.

Should we be making an effort in the Banking Committee, in this rewrite, to be talking or having in major users, or is there anybody who is focused and has a commitment in this, I ask, in particular, Mr. Corrigan, if you had reactions from users to your proposal? Are there thoughtful groups out there who would come in and give us a different window on what we are doing?

Mr. **Corrigan**. I regret to say that I am not very optimistic on that score, Senator, simply because the subject matter itself is so incredibly technical and complex. And one of the things that is true about our financial and banking system, which I think is great, but its base is that, you know, over a long period of time, it by and large has worked so well, that most people take it for granted. Now, take the simplest little thing like check clearing. Most people never even give it a second thought. But a check doesn't clear by accident. A check clears because we have managed to put together, over the past 50 years, a system that allows it to happen in a way that we all can be so casual about it.

So I wish I could point to a vehicle to achieve what is obviously a laudable purpose, but I am not sure I have an answer. The financial practitioners, the people that you have already heard from, I think, with few exceptions, they have been privately quite supportive, if not enthusiastic about some of the things I have talked about.

But I don't know. John, you may have a different view of this, but it is such a difficult subject matter.

Mr. **Heimann**. Senator, the best example I could give you is that for many, many years, the regulation Q remained on the books, and it was clear, for a good portion of that time, that individual savers in depository institutions were, in effect, subsidizing the mortgage market. There were some of us who tried to do something about that 10 or 15 years ago and got nowhere. And the only ones who could get everybody together on the subject were the Gray Panthers. The elderly people of this country who were receiving 5¼, 5½ percent on their passbook savings account, when the rate of inflation was 8 to 9 percent, finally geared up and really lobbied before the floors of the Congress. We got regulation Q changed.

The reaction is that this means very little to most people. It is on the margin of their lives. Since the system has worked so well over all and there have been so few problems, it is hard to create a constituency that will come down and argue for the systemic changes that are before this committee.

Senator WIRTH. So you are telling us then that—my time has expired—in the goal and the process in front of us, we are going to have to deal, essentially, with the providers in doing this, and that that goal, as I understand it from you-all, is twofold, one to square the circle, to use Mr. Corrigan's language and, second, to create an "it," some kind of an overall supervisory capability that will help us to harmonize functions at home and abroad. That is the double goal that we have. And that, it seems to me, again, Mr. Chairman, argues for the need to see how we take the bill introduced by Senators Proxmire and Garn and merge that with the overall proposal that we have been pushing, and that reaches the two goals that you-all have been talking about today.

Thank you, Mr. Chairman.

Mr. HEIMANN. I agree.

ATTRACTING AND MOVING CAPITAL

Senator RIEGLE. If I may, let me come back to where we were a moment ago, and that is—I am concerned about this question of being able to attract capital and move capital around, and there's several concerns I have that come off that. But the part I want to concentrate on is whether or not we are really creating a far more attractive entity, and entity that can raise more capital because of its profitability potential was greater, and so forth. And as I look at the world right now, I see the banks selling at low prices, historically. They have taken a beating on earnings, at least some of the big banks have, and so forth, and so bank multipliers are not abnormally high. This would not be a good time to have to go out and raise bank capital, from the point of view of diluting the equity.

The same is true of investment banking. Investment banking today is reaching for capital, but they are basically reaching overseas to get capital. But if we go to the approach that you are talking about, and we have it created, and we have got the levels of supervision, we prevent bank capital from leaking into the securities financial services affiliate, but we allow capital to come out of that affiliate into the bank as needed. And I am still trying to understand in my own mind how we have created something of substantially greater market value, because we have combined it. We are not going to allow tie-in sales. Some people don't even want to allow the use of the same name. So that if you are going to have banking services over here under a very well-known name with the Federal deposit insurance, you come over in the securities affiliate. They are going to do business over there, but perhaps not only not have the Federal deposit insurance but even have a different name, so that there is no confusion about it. There is no subtle pressure to take the service or any notion that somehow it is less risky than if somebody down the street is selling it not connected to a bank, and so forth.

So we are going to be very careful about all those things.

I am still reaching for the question of where the value enhancement comes from. What have we produced that has a greater capital attraction value, quite apart from how capital is going to get moved around here. And I think there may be something of an illusion here. I am not saying there is not some reality, but I think there is some illusion very much mixed in with it. And I am not sure how we, under that scheme, have created something that has substantially greater profitability potential, substantially higher capital raising potential, especially when you are sort of compartmentalized as to how capital can move around, because you are going to have limitations on tie-in sales. And I guess what I am wondering here—I can see how somebody says, well, what you are trying to do is, you are trying to move the structure to where the market is.

Well, the presumption of that is, the market is where we ought to be. I mean, the reason we have a structure in the first place is because we have decided over a long period of time there has to be a certain amount of structure through and around the market. I mean, there was a time when there was just a market and no structure, and so the structure was put in there for a purpose.

So you don't say that every time the market changes, you just sort of take down the structure and you rework the structure. Maybe you do, maybe you don't, maybe you do part of it. I think the question here is, what are the fundamental goals that we are driving at? And if the issue is profitability, then that is one very precise question. If it is capital formation under financial services, that is something else again.

If it is one-stop shopping, and that is what some people have in mind, then that is something else again. We can look at all these different things.

I asked Chairman Greenspan a week ago about profitability. Did we need to do this for bank profitability? His answer was not.

Mr. CORRIGAN. I would answer that question in those terms the same way, but I would also want to emphasize that what you see is not what you get. The problem in profitability in the banking industry is the problem of profitability as it is uniquely associated with the historic intermediation function, a function that, in my judgment, is crucial to the workings of the system as a whole. I don't think there is any question whatsoever that that element of traditional banking is under great pressure from a profitability point of view. What has happened is that the banks have been able, with a rather impressive degree of success, to cushion the loss of profitability there by the other activities that they have been able to engage in under existing law.

Senator RIEGLE. Such as?

Mr. **Corrigan**. Well, such as the kinds of securities activities they have right now, the trading activities in foreign exchange, government securities, interest rates swaps, currency swaps. And that, of course, reflects the reality of the worldwide marketplace. But I think the question about profitability is a part of what is at issue here. But when we talk profitability, Senator, I think it is important that we keep in mind two things. One is, the source of capital, by and large, for all companies, but perhaps especially financial companies, is internally generated capital. In other words, the retained earnings. And I think we have to ask ourselves the question on profitability is not just what is it now, but what would it be under all alternative scenarios.

And I think the point about profitability that is important, but not again, in and of itself—not decisive—is that the question of will the kind of structure that we are talking about here provide the product flexibility and the diversification opportunities that will permit both banks and securities companies to be able to better maximize their profits over time.

PRODUCT FLEXIBILITY AND DIVERSIFICATION

Senator **Riegle**. If I may say so, I think what you have just said, the last comment about maximizing and product diversification, and so forth, I think that is—that is sort of a standard phrase that has developed. I don't demean it or the way you expressed it by saying that, but that is sort of a euphemism, and out of that has to come some very clear discernible advantages, especially when we are talking about still safety and soundness, access to the Fed window.

We are talking about Federal Deposit Insurance, and if we are talking about—I think you are, in turn, you have to go through the product mix to profitability. There are a lot of ways to get the profitability. We can pay interest on reserve deposits, for example, and that will enhance profitability. We can change tax rates. That will enhance profitability. We can expand product lines. We could take maybe some products that have been peeled off by other competitors over a period of time and maybe pull those back and give those to the banks, because they become hybrid type activities.

I mean, that is sort of the step-by-step approach. Or we could go the way you are saying, and that is, set up a securities affiliate, go full bore into the securities business and put all the firewalls in place. We are going to have a new regulatory structure on top of that, which I concede as well, we would very clearly need. That doesn't come free. Somebody is going to pay for that. I assume the banks or this new entity is going to pay for that. The public is not going to pay for it.

So that becomes a new cost of doing business.

If, in the end, you are not back down to the point where you are affecting profitability and capital sufficiency, and whether it is retained earnings or the ability to attract additional capital, it seems to me that you may be involved in a word game, and that we may be involved in sort of chasing market activities that may not have anything to do in the end, if you are coming off the base of Federal deposit insurance in the Fed connection, and you want safety and soundness, you then move on over into profitability and into capital strength. I am not sure those things cross connect here. That is where I am having trouble understanding the proposition. I understand the structure of it, the form of it.

Where I am having trouble making the logic connections is how that gives us substantially stronger financial entities.

Mr. CORRIGAN. If we end up by design or by default with a series of financial institutions, regardless of what they are called, that cannot effectively compete in the marketplace, there is no way, in my judgment, Senator, that this Congress or any Congress is going to be able to pass laws to tinker around with the tax system, or whatever, that is going to be able to solve that problem.

Senator RIEGLE. But are you saying to me—and this is where I guess I have another problem.

Are you saying to me that our investment banking concerns can't compete today? The sense I have is, they are competing. I mean, that doesn't mean they make money every time, and the same with the banks.

Mr. CORRIGAN. Again, I am saying that there are a variety of considerations, including competitiveness, that seem to me to be pushing us inexorably in the direction of a more integrated financial system, and I say, inexorably, because I do think that the process, whether we like it or not, is basically being driven by technology and other market forces. And I would like to think that maybe there is some way we could stop that, but I don't see it that way.

You know, if you take it to an extreme, you know, you hear talk, for example, about banks giving up their charters. That is not what they will do. What they will do is, they will move to London, and they will have a branch in the United States.

I just don't see how you can make the transition from those types of circumstances. In fact, if I could, I would probably be the first to support it. I don't think my basic concerns are fundamentally very different than your own. And what I am trying to visualize is how do we maximize, not the profits of the system, the well-being of the system, in a context in which profitability itself is obviously essential to the well-being of the system.

Senator RIEGLE. John, I am going to have you respond, and then we will end this, because we could talk for a long time. John, why don't you respond, and then we will finish.

Mr. HEIMANN. Well, I will make this very brief.

First of all, I would like to say we used the word "market," and that is sort of one of these generalized words. "The market speaks." But in the financial service industry, the market is the user. That goes to Senator Wirth's question. That is what the market is.

The fact is most of the innovations and changes that have taken place in the financial system in the last ten years weren't driven by the institutions. They were fairly happy and comfortable with what they had, for the most part, they were driven by the users of the system. And you have to assume that will continue.

And then following on Jerry's point, it is clear that the system is becoming increasingly more integrated, which means more competitive. No matter how you look at this, there is increasing competition from both here and abroad, affecting the financial services industry.

So what that really comes down to at the bottom line, since the market is everybody and thrusts the system into a blurring of distinctions and a more integrated system, it increases competition. That absolutely mandates that the competitors of today are treated equally, so that they can live in this new world without a competitive disadvantage. You know, individual institutions can mess things up. They can do a terrible job and go out of business. That is not the issue. But to hamstring one side of the participants, negatively, so that they are less competitive for the time being, in a highly integrated competitive world, means weakening of that system.

That clearly can't be the intent of Congress. You want everyone to compete, but you don't want to purposely weaken somebody, and I think that is the problem we have in addressing the securities industry.

Second, if everyone is going to compete, you have to have someone or some thing to set minimum standards. In other words, you could run competition to the point where capital adequacy goes down to zero and liquidity ratios, et cetera. You could run competition to the lowest possible common denominator until you are really very, very hurtful to the system as a whole.

So there must be a standard-setting mechanism, which even in a competitive framework says, hey, fellows, you can't run your business anymore, unless you increase your capital, and you go do it, otherwise you are not going to be permitted to do A, B, C, D, whatever happens.

That, I think, is the bottom where I would come out.

Senator RIEGLE. Let me give you an analogy to that. We have had the market moving at light speed in financial markets with technology, with new products, with innovations, with other markets arising, and so forth, not just in this country, but around the world. We had a major market collapse not very long ago. We now have a host of study groups at work to try to figure out how that happened and what changes might be made. There are recommendations leaking out today of things that might he done, in terms of imposing trading limits on the day and doing something about interdicting, maybe, the cross connection between different kinds of financial instruments, and so forth, without in any way trying to draw any lessons from that, because we have got all these study groups going.

It seems to me there are two lessons in that. We are finding—or at least there is a strong supposition by many that some things went wrong that are not just basic economic realities and reactions. There may have been something wrong in the mechanics, and there were a lot of people, very smart people hard at work at that.

We are about—we don't know the answers to that yet, but what we are really talking about doing is basically taking a large part of that system and now connecting it to the banking system, albeit with safeguards.

That is sort of a separate point, but I guess what I am saying is that when markets go out and do things where you have got the need for a structure of Government regulation, what markets do isn't necessarily what is in anybody's best interest in the end, and that is why the structure came after the markets, and why the structure has to come in, and I think, basically, set up a framework, and it has to work, and it doesn't necessarily mean that you take the market realities and then just fashion a new structure to fit around what the market has done. You may have to take and shave off certain things, back up certain things, push certain things forward, set new standards.

I don't foreclose viewing it that way, and in a way that in the end comes back down to whatever the basic objectives are that we are trying to meet here. If we've got competition going on in all these areas, we don't have over concentration, we've got sufficient profitability, we've got safety and soundness. I mean, those are the goals that I want to see perpetuated. Somebody else might say, well, wait a minute, I've got—I don't want to do all that that way, because I've got another idea. That may be interesting, but it may well be that that idea has to sit in a framework that maintains this other balance, and if it doesn't, then maybe it can't be accommodated.

Thank you for your patience today. You have been very helpful.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM KENT W. COLTON

Riegle Question: What should be done about Glass-Steagall at this point? Should it be replaced?

The National Association of Home Builders has not taken a formal position on the repeal of Glass-Steagall; however, we have serious reservations about total repeal of the Act. It would create uncertainty in the market-place which would be counterproductive either now or in the future. The securities industry has not settled down from the events which caused the stock market to fall over 500 points on October 19. While much of that was caused by perceptions, there is still a nervousness which is prominent in the investment community.

The Glass-Steagall Act set up certain principals which are still sound today. The separation of banking from commerce still protects our system from economic concentration of the banking and the securities industry. The prospect of creating more financial institutions which are too big to fail is a result which we believe should be examined very carefully. One only needs to look at Continental Illinois and the resulting bail-out of the holding company to comprehend the reality of that possibility.

Modernization of the Glass-Steagall Act, that would specifically give banks selected new securities powers, is a different issue than repeal. We do strongly support expansion of securities activities in the areas of mortgage related securities and mortgage revenue bonds, so long as there are adequate consumer safeguards to protect the depositor, the investor and the economic system. The market-place is moving toward new investments and to ignore the realities of that movement would be a mistake. We believe the consumer and the housing industry could be well served if banks and thrifts were allowed to underwrite and deal in mortgage-related securities. Currently that market is highly concentrated with 10 firms underwriting 96 percent of the mortgage-backed securities. This is an area where we feel competition is needed. We would also include mortgage revenue bonds in the list of new powers which we believe are closely related to the business of banking and fit within the principals of safety and soundness.

We firmly believe that any legislation which Congress enacts must address the question of new real estate powers. To ignore that issue and let federal and state regulators determine permissible real estate investments would be a mistake. Equity positions in real estate projects, particularly where the financial institution would be actively and directly investing in real estate development, should be prohibited. If Congress is not prepared to determine which real estate activities should be prohibited, then the moratorium should be extended for one year in this area so that it is clear to the regulators that Congress will decide this issue. When Congress is satisfied that ongoing studies have been completed on the issue, and it is prepared to make a decision on specific prohibitions, then legislation should spell out those activities which are permissible and those which are prohibited.

Our statement addresses the scope of investments and the "closely related" test. Any passive investment, if it is to be construed as "closely related to banking and a proper incident thereto," should be structured as the functional equivalent of a loan. Speculative acquisitions of undeveloped or partially developed land to be held for investment or future development are incompatible with the "closely related" test and should be prohibited.

We further believe that it is appropriate for Congress to determine the extent to which it will allow federal insurance to cover high risk investments. Many states permit their state-chartered institutions to directly develop real estate--thereby exposing the federal deposit insurance system to potential payouts from liquidating or merging insolvent institutions. And, as we have witnessed in the oil producing states, real estate values declined--in some instances to half the original appraised value--and pushed many institutions into insolvency.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM GEORGE D. GOULD

A. In Fed Chairman Greenspan's testimony yesterday and your testimony this morning, you both mention somewhat fondly if not with total approval of various studies and legislative proposals that are broader than the Financial Modernization Act. However you do not appear to endorse the more comprehensive reforms contained in these various proposals.

Question

Q. 1. Is your reluctance to endorse broader reforms due to your opposition to such reforms or because the Treasury has made the political judgment to seek only the limited reform contemplated in the Financial Modernization Act?

Question

Q. 2. If so, what was the basis of this "political judgment?"

ANSWER

Because we were given less than 24 hours to present an Administration position, it was not possible for us to evaluate all the proposals and develop a formal Administration position on each of them, as I indicated in my letter to Senator D'Amato, dated December 3, 1987. Thus, our inability to endorse broader reforms than those contemplated in the Financial Modernization Act was not based on a political judgment to seek only limited reform. Instead, the Administration has endorsed the Proxmire-Garn bill as a first step toward broader reform, such as S. 1905, the Depository Institution Affiliation Act. Moreover, adoption of the Financial Modernization Act does not preclude future reform and is not inconsistent with the way further reform ought to proceed.

Question

Q. 3. Has the Treasury or the Administration made the decision to reject or oppose any of the broader reform schemes embodied in the FDIC proposal, Mandate for Change or in my legislation?

ANSWER

No. We remain open-minded on all of these proposals.

Question

Q. 4. Your responses to my written inquiries pursuant to your testimony of January 21, 1987, greatly influenced many provisions of the Depository Institution Affiliation Act - S. 1905. In response to a question which concerned the affiliation of commercial entities and depository institutions you responded:

You ask why -- if commercial firms already can affiliate with securities firms and securities firms should be able to affiliate with banks -- commercial firms should not also be able to affiliate with banks. Commercial firms already are affiliated with depository institutions in many cases through such existing mechanisms as the unitary thrift holding company. I can find little wrong with such operations, so long as the depository institution component is properly regulated and supervised just as a free standing bank owned by individual merchants in a small town would be. I want to work with Congress to pass meaningful legislation to promote a freer, more open financial services marketplace that benefits consumers and industry alike.

Do you still support the idea that the "barrier" between commerce and banking can be torn down to permit the affiliation, in a holding company structure, of depository and commercial entities without adversely affecting the safety and soundness of the financial system?

ANSWER

There are many examples of affiliations between commerce and banking today that have arisen from such "loopholes" as unitary thrift holding companies, limited purpose banks that were grandfathered under the Competitive Equality Banking Act, and industrial banks. They are providing significant benefits to consumers and strengthening the combined organizations without undue risk to the financial system. The Proxmire-Garn bill would take the next logical step by specifically authorizing affiliations for banking and securities firms through the holding company structure subject to proper regulatory safeguards.

Question

B. Why shouldn't Congress at this time modernize antiquated laws that restrict the free flow of capital into all financial intermediaries, impede the positive forces of competition, and produce a creaky patchwork regulatory structure that was never intended for today's markets?

ANSWER

As I stated in my testimony, there is an urgent need to modernize our nation's financial services industry to better serve consumers and business. This need has spawned a large number of reform proposals that are worthy of serious consideration by the Congress. We believe the Proxmire-Garn legislation to remove the separation between commercial and investment banking provides the proper starting point for broader reform.

Question

C. Q. 1. Do you believe that banks are "special" and therefore shouldn't be affiliated with commercial industrial concerns who might somehow abuse the payments system, etc?

ANSWER

Banks (or depository institutions in general) are "special" only insofar as the safety of their deposits is underwritten by federal deposit insurance and their direct access to the payments system. It is this federal safety net that makes insured depository institutions different from other firms, and requires that any affiliation of an insured depository with other financial or commercial firms be conditioned on the proper insulation of the insured depository from the risks that might be posed by those other firms.

Most of the current proposals for financial restructuring accept the principle of corporate separateness and insulation of the insured depository, although differences exist with respect to exactly what constitutes a sufficient "firewall." It is our opinion that any firewall must be created with several goals in mind: first, to avoid transfer of risk to the insured depository from any affiliated entities; second, to avoid passing on whatever deposit insurance subsidy might exist for the insured depository to its affiliated firms, thereby preventing unintended competitive inequities; and finally, to prevent any increase in risk to the nation's payments system that might occur if an insured depository were used by an affiliate to effect risky funds transfer.

A number of statutory and regulatory provisions already exist for the purpose of addressing the above concerns. Moreover, legislative proposals such as S. 1886, S. 1891, and S. 1905 all contain provisions intended to further insulate the insured depository from the risks of affiliates. These additional provisions, in combination with the fact that no apparent difficulties have been encountered with numerous existing affiliations, should be sufficient to minimize concerns over affiliations between insured depository institutions and other firms. Over the long term such affiliations can be expected to attract much needed new capital to depository institutions and thereby strengthen the overall safety and soundness of the banking system.

Question

Q. 2. Why couldn't a holding company have an industrial and a bank subsidiary with the proper insulation and legal separateness?

ANSWER

As referenced earlier, there are many existing cases of insured depository institutions being affiliated with commercial/industrial firms in a holding company framework. This is clearly the case with respect to any number of unitary thrift holding companies and limited service banks. To the best of our knowledge, these affiliations have not resulted in undue concerns over the safety and soundness of the banking system or threats to the proper functioning of the nation's payments system. We view this experience as just one more reason why legislation should now be enacted to initiate an orderly, step-by-step expansion of the delivery of financial services to consumers.

Question

Q. 3. If the holding company structure can be used to institutionalize the separation between a bank and a securities affiliate, then why not between bank and any other affiliate and parent?

ANSWER

We have long supported the notion that the holding company structure can be used to institutionalize the separation between an insured depository and affiliate firms engaged in a wide range of other activities. From a public policy viewpoint, the least disruptive approach to authorizing such affiliations for all insured depository institutions appears to us to be on an incremental basis. In this way, the demands of the operating environment will not change too drastically in too short a time period for efficient adaptation by both institutions and their regulators. In this respect, the legislation proposed by Senators Proxmire and Garn seems to be the most appropriate for immediate consideration. Barring any major difficulties, Congress would be in a position to consider further restructuring in the future.

Question

Q. 4. If an adequate firewall can be built to insulate the commercial banking and investment banking affiliates, can't a similar firewall be erected to insulate the depository institution from all affiliates, including a commercial affiliate, of the holding company?

ANSWER

A firewall adequate to insulate the insured depository institution from all affiliates, including a commercial affiliate, probably could be erected. The restrictions imposed on transactions between the insured depository and its affiliates in the Proxmire-Garn proposal, as well as the similar restrictions you propose in S. 1905, are consistent with the types of firewall provisions we have endorsed for some time now. The actual effectiveness of such firewalls will be documented over time as the products and services of banking organizations are progressively expanded, affording regulators opportunities to make required changes, if needed, to maintain the safety and soundness of the banking system.

Question

D. Q. 1. In responses to Senator Proxmire you stated that the Administration supports the Proxmire-Garn proposal. Does your support for that proposal preclude your support for other, broader proposals such as the Depository Institution Affiliation Act ("DIAA")?

ANSWER

No. The Proxmire-Garn proposal, in our opinion, represents the best next step for modernizing the delivery of financial services and does not preclude further restructuring.

Question

Q. 2. If you do not support such a broader reform package, would the Treasury work to directly or indirectly oppose the DIAA?

ANSWER

No.

Question

E. Q. 1. In response to Senator Proxmire's written question 2 pursuant to your January 21, 1987, testimony you suggest that you would support a broader grant of powers. You responded:

> It has become more and more apparent to us over time that all financial service providers are going to need a wide range of service authorities in order to be effective competitors in the current and future marketplace. Whereas not very long ago the extension of a short list of new activities to banking organizations may have been an optimal starting point for the restructuring of our financial institutions,

> that seems much less the case today. The pace of financial innovation has been much too rapid for us to focus only on those additional powers encompassed by mutual funds, commercial paper, mortgage-backed securities and municipal revenue bonds. For example, in just the past year securitized consumer loans have become an important element in the investment portfolios of some financial services providers. Moreover, there is every reason to believe that additional innovative products will continue to come to market to the detriment of overly regimented institutions, especially our traditional depositories.

Do you no longer hold this viewpoint in light of your support of the Financial Modernization Act?

ANSWER

Our support for the Financial Modernization Act is consistent with my earlier statement to the Committee.

Question

Q. 2. In your response to question 2 you go on to state:

> The safety and soundness of our financial system will ultimately be based upon the ability of the system to attract capital. The required capital will be attracted to the system if reasonable profitability can be maintained in the face of various economic and financial market events. This means that the management of financial organizations must have the discretionary ability to alter the composition of services offered and investments made according to their own competitive strengths, not regulatory fiat.

Do you believe that the Depository Institution Affiliation Act, which permits affiliations between depository and commercial entities, enhances the ability of the system to attract capital?

ANSWER

Yes.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM L. WILLIAM SEIDMAN

To respond to Senator Riegle's request for data concerning the profitability of Michigan banks over the past five years, the following statistics are provided.

	1981	1982	1983	1984	1985	1986	1987*
Number of FDIC-insured banks	375	374	371	365	361	345	321
Aggregate assets (billion)	$56.5	$59.0	$64.0	$67.8	$72.8	$78.9	$79.4
Aggregate deposits (billion)	46.1	48.2	52.5	56.0	60.1	64.7	65.2
Number of FTE bank employees	48,149	45,916	46,261	45,435	46,040	46,167	46,564
Aggregate equity-to-assets ratio	6.28%	6.27%	6.14%	6.23%	6.24%	6.19%	6.45%
Aggregate ratio of net loan charge-offs to loans	0.38	0.63	0.58	0.48	0.46	0.51	0.24
Aggregate ratio of nonperforming loans to total loans	N/A	3.11	2.45	1.89	1.75	1.44	1.33
Weighted-average return on assets:							
All banks	0.53%	0.51%	0.61%	0.78%	0.80%	0.78%	0.80%
Banks smaller than $100MM	0.60	0.63	0.69	0.74	0.75	0.70	0.95
Banks larger than $100MM	0.51	0.48	0.60	0.79	0.81	0.79	0.78
Proportion of banks that were unprofitable:							
All banks	10.9%	14.4%	11.3%	10.1%	9.1%	9.9%	6.9%
Banks smaller than $100MM	12.5	14.6	13.3	12.8	10.9	12.4	9.7
Banks larger than $100MM	5.8	14.0	5.9	3.7	5.3	5.0	1.8

Distribution of FDIC-Insured Banks in Michigan by Return On Assets Ratio

Return On Assets	1982	1983	1984	1985	1986	1987*
Less than 0.00%	14.4%	11.3%	10.1%	9.1%	9.9%	6.9%
0.00 to 0.75%	41.4	40.0	31.0	25.8	28.1	22.1
0.75 to 1.50%	41.4	42.6	54.2	59.8	55.7	62.0
Greater than 1.50%	2.7	6.2	4.7	5.3	6.4	9.0

Please see the attached sheets:

1. Selected ratios of insured commercial banks for the state of Michigan
2. Summary information for all banks in the state of Michigan

Both of these statistical summaries provide ratios generated by the Uniform Bank Performance Report system, and represent unweighted average values except where otherwise indicated.

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* - Please note that figures for 1987 are as of September 30, and that 1987 performance ratios are annualized. All other statistics are period-end/full-year figures.

SELECTED RATIOS OF INSURED COMMERCIAL BANKS FOR THE STATE OF MICHIGAN

	25TH %TILE	50TH %TILE	75TH %TILE	ADJUSTED MEAN
BANKING STATISTICS FOR THE PERIOD ENDING 09/30/87 (TOTAL NUMBER OF BANKS 321)				
NET INTEREST INCOME / AVG EARNING ASSETS	4.16	4.64	5.07	4.61
NET INCOME / AVERAGE ASSETS	0.69	1.00	1.25	0.98
NET INCOME / AVERAGE TOTAL EQUITY	9.52	13.21	16.57	12.66
TOTAL NONCURRENT LNS&LS / TOTAL LNS&LS	0.58	1.15	2.03	1.49
TOTAL NONCURRENT AND ORE / TOTAL ASSETS	0.47	0.89	1.57	1.14
NET CHARGE-OFFS / AVERAGE TOTAL LNS&LS	0.09	0.21	0.41	0.27
EQUITY CAPITAL / TOTAL ASSETS	6.60	7.33	8.71	7.70
PRIMARY CAPITAL/ADJUSTED AVERAGE ASSETS	7.44	8.10	9.36	8.44
BANKING STATISTICS FOR THE PERIOD ENDING 12/31/86 (TOTAL NUMBER OF BANKS 345)				
NET INTEREST INCOME / AVG EARNING ASSETS	4.32	4.83	5.28	4.81
NET INCOME / AVERAGE ASSETS	0.57	0.94	1.17	0.87
NET INCOME / AVERAGE TOTAL EQUITY	8.39	12.01	15.57	11.56
TOTAL NONCURRENT LNS&LS / TOTAL LNS&LS	0.63	1.18	2.20	1.58
TOTAL NONCURRENT AND ORE / TOTAL ASSETS	0.51	0.93	1.81	1.21
NET CHARGE-OFFS / AVERAGE TOTAL LNS&LS	0.17	0.36	0.74	0.48
EQUITY CAPITAL / TOTAL ASSETS	6.20	6.96	8.15	7.29
PRIMARY CAPITAL/ADJUSTED AVERAGE ASSETS	7.16	7.75	8.98	8.15
BANKING STATISTICS FOR THE PERIOD ENDING 12/31/85 (TOTAL NUMBER OF BANKS 361)				
NET INTEREST INCOME / AVG EARNING ASSETS	4.40	4.85	5.25	4.85
NET INCOME / AVERAGE ASSETS	0.62	0.95	1.17	0.88
NET INCOME / AVERAGE TOTAL EQUITY	8.66	12.61	15.60	11.84
TOTAL NONCURRENT LNS&LS / TOTAL LNS&LS	0.78	1.46	2.75	1.90
TOTAL NONCURRENT AND ORE / TOTAL ASSETS	0.60	1.14	2.22	1.52
NET CHARGE-OFFS / AVERAGE TOTAL LNS&LS	0.15	0.32	0.61	0.43
EQUITY CAPITAL / TOTAL ASSETS	6.29	7.03	8.12	7.28
PRIMARY CAPITAL/ADJUSTED AVERAGE ASSETS	7.05	7.78	8.87	8.04
BANKING STATISTICS FOR THE PERIOD ENDING 12/31/84 (TOTAL NUMBER OF BANKS 365)				
NET INTEREST INCOME / AVG EARNING ASSETS	4.18	4.62	5.14	4.69
NET INCOME / AVERAGE ASSETS	0.56	0.86	1.08	0.83
NET INCOME / AVERAGE TOTAL EQUITY	7.53	12.03	14.62	10.83
TOTAL NONCURRENT LNS&LS / TOTAL LNS&LS	0.85	1.54	2.67	1.90
TOTAL NONCURRENT AND ORE / TOTAL ASSETS	0.65	1.29	2.12	1.58
NET CHARGE-OFFS / AVERAGE TOTAL LNS&LS	0.15	0.32	0.65	0.46
EQUITY CAPITAL / TOTAL ASSETS	6.25	7.09	8.07	7.26
PRIMARY CAPITAL/ADJUSTED AVERAGE ASSETS	6.96	7.77	8.56	7.95

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM L. WILLIAM SEIDMAN

Senator Garn - Question 1 - The Proxmire-Garn Bill creates a special exemption from some, but not all, bank holding company regulation for certain "pure" securities firms that buy banks. The exemption applies if 80 percent of the assets and revenues of the combined organization, including the bank, is related to securities activities. This is designed to make it more attractive for securities firms to buy banks, to make it more of a "two-way street," but the problem is that many securities firms are engaged in other financial activities that are prohibited by the Bank Holding Company Act. These firms would have to give up these other activities in order to acquire a bank. Would you favor an additional exemption from the activities restrictions of the Bank Holding Company Act for firms primarily engaged in securities activities or financial activities? If so, what suggestions would you make?

We believe that competitive equality in the financial services industry should be a primary goal of financial services reform. This equality demands that competition be a "two-way street." That is, if banks are allowed to enter the securities field, securities firms should be allowed to enter the banking field.

Through the repeal of Sections 20 and 32 of the Glass-Steagall Act, the Proxmire-Garn bill, S. 1886, takes an important first step toward competitive equality in the financial services industry. The FDIC, however, believes that total competitive equality ultimately will require the elimination of all the activity restrictions contained in both the Bank Holding Company Act and the Glass-Steagall Act. Until that time, the goal of total competitive equality -- the proverbial "two-way street" -- can be only partially realized. Indeed, such a "two-way street" between securities firms and banks will not be assured, as many securities firms are presently affiliated with companies engaged in activities not permitted to bank affiliates under Bank Holding Company Act restrictions. These firms could not acquire a bank without first giving up these other activities.

To address this problem, we suggest that the bill's current special exemption from Bank Holding Company Act restrictions be broadened to encompass firms that engage in any financial activity so long as a large proportion of the assets of the combined organization is related to securities activities. More specifically, we recommend that firms that are engaged at least 80 percent in financial activities other than banking be exempt from the activities restrictions of the Bank Holding Company Act, so long as at least a majority of the firms activities consist of securities activities.

We recognize that the primary interest of the banking reform legislation under discussion lies in correcting the problems associated with the Glass-Steagall Act, and not in breaking down the Bank Holding Company Act. This underlies our recommendation that the overall level of securities activities remain the primary factor in determining whether an organization that conducted some banking activities should be exempt from some provisions of the Bank Holding Company Act. However, unless some provisions are made to relax the activity restrictions of the Bank Holding Company Act as well, it will not be possible to move toward a "two-way street." If implemented, we believe our recommendation could make a significant contribution toward the establishment of a viable "two-way street" between banks and securities firms.

Senator Garn - Question 2 - It seems to me that any restructuring plan enacted into law should require increased supervisory resources for the regulators, especially in the initial years of operation. Do you agree?

The FDIC fully agrees with Senator Garn that the flexibility to increase regulator's supervisory resources must be an integral part of any restructuring plan. We believe the tools we currently have at our disposal are sufficient. If conditions change and we find we need additional flexibility to maintain adequate supervisory oversight, we would welcome Congressional input and support in this area.

Senator Garn - Question 3 - Federal Reserve Chairman Greenspan testified that holding company capital should be sufficient to absorb losses from securities affiliates and at the same time serve as a "source of strength" to the bank. On the other hand, some have suggested that there should be an explicit prohibition against requiring extra capital in holding companies that have securities affiliates -- it has been suggested that holding company capital should not be regulated at all by bank regulators. Could you please comment?

The FDIC has suggested that there should be an explicit prohibition against requiring extra capital in holding companies that have securities affiliates. We also have suggested that holding company capital should not be regulated at all by bank regulators. That is, irrespective of whether or not the holding company has a securities affiliate, we believe that there is no need to regulate the capital of the holding company. This recommendation is consistent with our belief that the holding company should not be regarded as a "source of strength" for its subsidiaries.

These suggestions stem from our belief that functional regulation is critical to financial restructuring. Specifically, functional regulation avoids layers of regulation and duplication that result when companies are under the jurisdiction of multiple agencies. This is consistent with our belief that one of the principle objectives of bank reform should be to find the least-cost, simplest alternative, within acceptable bounds of safety and soundness. In addition, functional regulation is fundamental to establishing competitive equality among all securities firms, irrespective of whether they are affiliated with a bank.

Based on this principle, we believe that regulation and supervision of bank securities affiliates should be housed solely in the appropriate functional regulator -- the Securities and Exchange Commission. Similarily, we believe that the regulation and supervision of the bank should be the sole responsibility of the bank regulators. Therefore, from the standpoint of functional regulation, there is no need for the Federal Reserve Board to require extra holding company capital based on a banking firm's affiliation with a securities firm.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
L. WILLIAM SEIDMAN

Senator D'Amato's - Question 1 - A. It seems to me that Chairman Seidman raises the pivotal question: Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound even from their owners, affiliates and subsidiaries? B. If a regulatory framework can be devised to establish an effective firewall that insulates banks from their securities affiliates, then shouldn't such a firewall also enable banks to be insulated from their commercial affiliates? C. S. 1905, The Depository Institution Affiliation Act, creates such a firewall; however, do you think this wall can be strengthened? If so, how?

We are pleased to find ourselves in agreement with Senator D'Amato in regard to the fundamental issue of financial restructuring: Can we create a wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? We believe the answer to this pivotal question is yes; such a supervisory wall or "firewall" can be created. It then follows that, given an effective supervisory wall, there is no reason to legislate the separation of commercial banking from securities activities and, for that matter, in the longer term from other financial and nonfinancial activities. In answer to your question, we believe that if such a supervisory wall can effectively insulate banks from their securities affiliates, it will enable banks to be insulated from their nonfinancial or commercial affiliates as well.

The supervisory wall or "firewall" created by S. 1905, The Depository Institution Affiliation Act, insulates and protects the banking system primarily through the use of higher capital requirements, expanded restrictions on relationships with affiliates, and broader examination and enforcement authority combined with severe civil and criminal penalties. While S. 1905 takes considerable steps toward the establishment of an effective supervisory wall, it could be strengthened.

The tools that we identified as necessary for insulating banks and establishing the supervisory wall are only a logical extension of safeguards contained in existing law to protect banks from insider abuse and conflicts of interest. Those tools are discussed in detail in our study, Mandate for Change: Restructuring the Banking Industry. They include (1) the transaction limitations contained in Sections 23A and 23B of the Federal Reserve Act, (2) the exclusion of investments in nonbanking subsidiaries in determining bank regulatory-required capital, (3) the authority to audit both sides of any transactions between a bank and its affiliates or subsidiaries, (4) flexibility for bank supervisors to collect financial data from affiliated nonbanking entities, to prohibit any transactions deemed to jeopardize the safety and soundness of banks and to require that activities which pose undue risk be housed outside the bank, and (5) additional penalties for those who violate the rules. Many of these tools already are included in S. 1905. Incorporation of those remaining tools, we believe, would strengthen the supervisory wall.

Senator D'Amato's Question 2 - Both S. 1891 and S. 1905 would establish a new regulatory mechanism with responsibilities over the financial services sector that consists of the heads of many existing financial agencies and other government entities. Do you prefer the Financial Services Committee concept in the D'Amato/Cranston bill or the Commission called for in the Wirth/Graham bill?

We believe that a fundamental objective of financial restructuring is to find the simplest and least costly approach that is consistent with safe and sound banking principles. Therefore, of those two proposed regulatory mechanisms, the National Financial Services Committee created by S. 1905 is preferred. Unlike the commission created by the "Financial Services Oversight Act," S. 1891, this committee would provide a forum that would facilitate the process of financial restructuring without imposing an additional and, we believe, quite burdensome layer of bureaucracy.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CHAFEE FROM L. WILLIAM SEIDMAN

Senator Chafee - Question 1 - Assume that a bank's securities activities are split among the bank, a securities subsidiary of the bank and a securities affiliate. Assume the SEC would have functional regulation of the securities subsidiary and the securities affiliate. Specifically which securities activities should be in each of the three? (You may decide that you do not wish to use all three.)

As we have stated in both our study, Mandate for Change: Restructuring the Banking Industry and in our December 3, 1987 testimony before this committee, if banks are adequately insulated, then from a safety and soundness viewpoint, it is irrelevant whether securities and other nonbanking activities are undertaken in bank subsidiaries or holding company affiliates of the banks. Therefore, we would suggest that banks should be permitted to choose to undertake new securities activities in a bank subsidiary or a holding company affiliate, depending on their preferred corporate structure. Given an appropriately insulated banking system, the specific activities carried out in these subsidiaries or affiliates could be left to the discretion of the parent bank or holding company. Ultimately, we believe that all the activity restrictions contained in both the Glass-Steagall and the Bank Holding Company Act should be phased out.

In addition, we feel there are certain "securities" activities which should be considered "banking" and therefore should be permitted within the bank itself. Among these are the underwriting and sponsorship of mutual funds, the underwriting of commerical paper, securitized assets, and municipal revenue bonds, and as included in S. 1886, the underwriting and sponsorship of unit investment trusts.

Senator Chafee - Question 2 - Do you feel that present civil dollar and criminal dollar and incarceration penalties with regard to illegal banking activities are sufficient? If not, what improvements in the law should be made?

The maintenance of a strong supervisory wall demands that sufficient penalties with regard to illegal banking activities be established and enforced. The FDIC does not believe, in general, that the present penalties with regard to illegal banking activities are sufficient. Present civil dollar penalties need to be uniformly enforced on an expanded level. Throughout the past year, the FDIC has participated in an interagency working group to examine, among other things, how these penalties might be improved. The interagency recommendations can be found in The Enhanced Enforcement Powers Act of 1987, which was recently introduced by Senators Proxmire and Garn as S. 1974. Beyond the corrections proposed by S. 1974, we believe that the expanded penalties found in Senators D'Amato and Cranston's bill, S. 1905, would be beneficial and deserve the Committee's consideration.

In the case of criminal penalties, the FDIC continues to recommend that the sentencing guidelines place greater emphasis on restitution. As insurer of bank deposits, we believe that restitution must be viewed as an integral part of the criminal justice system. We believe the overall sentencing policy should reflect the value and importance of restitution. These views have been expressed to The United States Sentencing Commission.

While we believe that the Bank Fraud statutes, in general, adequately deal with offenders, enforcement of the statutes could be improved if additional manpower, e.g., FBI agents and prosecutors, were available.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE TO MR. SILVER

Q. 1. In your prepared testimony you expressed great concern over the conflicts of interest inherent in the relationship between banking and securities activities. I too am concerned about these problems. But you clearly give a false impression by suggesting that they are particular to bank-affiliate relations.

Many of the holding companies which market mutual funds also contain mortgage lending affiliates and securities underwriting affiliates. Two that come to mind are 1) Sears & Roebuck, which owns Coldwell Banker, and Dean Witter; and 2) Merrill Lynch.

a. Couldn't Merrill Lynch or Sears be subject to the same "enormous incentive" to dispose of their low quality loans through a securities affiliate engaged in mortgage-backed securities underwriting?

b. Would you recommend that Sears and Merrill Lynch divest of these activities on the grounds of conflict of interest?

For the record would you please submit a list of the largest 25 mutual fund complexes and for each of the 25 a list of the corporate affiliates of the mutual fund.

Concern over the conflicts of interest inherent in the relationship between commercial banking and securities activities is not based on theoretical speculation, but on the historical record -- more precisely on the abuses which occurred when commercial banks and their securities affiliates sponsored mutual funds and underwrote securities in the 1920s and when banking organizations sponsored real estate investment trusts in the early 1970s.

One of the myriad abuses of the 1920s arising from the combination of commercial banking and securities activities involved bank sales of low quality commercial loans held in their portfolios to investors. A classic example of this type of abuse involved the sale in 1927 by National City Bank (now Citibank, N.A.) of practically worthless Cuban sugar loans to its publicly-owned securities affiliate, the National City Company, for $25,000,000. "Thus the bad loans of the Bank were cleared from its books. In due course, the National City Company wrote down its investment in the stock of the General Sugar Corporation to the munificent sum of exactly $1. ... The Bank was 'bailed out' of $25,000,000 of bad loans by its affiliate with money supplied by the stockholders themselves." (Pecora, Wall Street Under Oath (1939) at 122).

There are indications that, if the Glass-Steagall Act is repealed to permit banks to reenter the securities business, similar abuses involving bank sales of low quality loans will occur. Indeed, in a recent article urging repeal of Glass-Steagall, a vice president of Citibank sought to defend the bank's 1927 Cuban sugar loan transaction since it benefited the bank: "The bank received cash in lieu of a doubtful asset; this lowered the risks to which depositors were exposed -- an example of how an investment banking affiliate can strengthen the position of a commercial bank." (Huertas, "An Economic Brief Against Glass-Steagall", Journal of Bank Research, Autumn 1984).

SUMMARY INFORMATION FOR BANKS IN STATE OF MICHIGAN

	AVERAGE OF ALL BANKS IN STATE					WITH ASSETS - $MILL (12/31/86)		
	12/31/86	12/31/85	12/31/84	12/31/83	12/31/82	0-25	25-100	100+
TOTAL ASSETS ($MILLIONS)	78,920	72,812	67,768	63,958	58,953	702	10,668	67,551
NET INCOME ($MILLIONS)	616	585	531	393	298	4	76	536
NUMBER OF BANKS IN TABULATION	345	361	365	371	374	40	187	118
EARNINGS AND PROFITABILITY								
NET INT INC (TE) TO AVG ASSETS	4.43	4.46	4.28	4.14	4.18	4.40	4.56	4.24
+ NON-INT INC TO AVG ASSETS	0.65	0.64	0.67	0.60	0.57	0.58	0.58	0.79
- OVERHEAD EXP TO AVG ASSETS	3.23	3.24	3.19	3.25	3.33	3.65	3.20	3.14
- PROV FOR LOSSES TO AVG ASST	0.32	0.32	0.34	0.27	0.24	0.28	0.33	0.32
= PRETAX OPERATING INCOME (TE)	1.52	1.51	1.41	1.21	1.12	0.98	1.59	1.59
+ SECURITIES GAINS (LOSSES)	0.03	0.02	0.00	0.00	0.01	0.02	0.02	0.04
= PRETAX NET OPER INC (TE)	1.59	1.57	1.39	1.20	1.12	1.07	1.65	1.67
NET OPER INC TO AVG ASSETS	0.87	0.87	0.81	0.72	0.64	0.60	0.91	0.89
ADJ NET OPER INC TO AVG ASSETS	0.94	0.98	0.91	0.77	0.67	0.62	0.99	0.98
NET INCOME TO AVERAGE ASSETS	0.88	0.88	0.82	0.73	0.64	0.62	0.91	0.90
INT INC (TE) TO AVG EARN ASSTS	10.54	11.46	12.09	11.48	12.83	10.73	10.70	10.22
INT EXPENSE TO AVG EARN ASSTS	5.75	6.60	7.45	6.99	8.26	5.87	5.78	5.65
NET INT INC-TE TO AV EARN ASST	4.80	4.85	4.69	4.54	4.62	4.86	4.93	4.59
LOAN & LEASE LOSSES & RESERVES								
NET LOSS TO AVG TOT LOAN&LEASE	0.47	0.43	0.47	0.45	0.45	0.57	0.50	0.41
EARNINGS COVERG OF NET LOSS(X)	9.75	11.55	11.29	8.74	7.17	5.03	9.91	10.94
LOSS RESERVE TO NET LOSSES(X)	4.75	4.81	4.20	3.80	3.40	2.78	4.50	5.72
LOSS RESV TO TOT LOANS & LEASE	1.27	1.18	1.08	1.01	0.98	1.37	1.24	1.29
LIQUIDITY AND RATE SENSITIVITY								
VOLATILE LIABILITY DEPENDENCE	-23.80	-22.17	-23.38	-23.75	-26.37	-28.37	-25.78	-19.09
NET LOANS & LEASES TO ASSETS	52.68	53.58	53.20	50.23	49.73	52.03	52.54	53.12
CAPITALIZATION								
MEMBER PRIM CAP TO AVG ASSTS*	8.16	8.03	7.94	7.83	8.08	8.04	8.56	7.56
NONMEMBER PRIM CP TO AV ASST*	8.15	8.02	7.94	7.83	8.08	8.04	8.55	7.56
CASH DIVIDENDS TO NET INCOME	38.01	36.53	34.74	34.05	35.80	25.89	36.42	43.83
RET EARNS TO AVG TOTAL EQUITY	6.37	6.81	6.68	5.47	4.77	5.11	6.43	6.69
GROWTH RATES								
ASSETS	7.39	7.20	7.38	9.56	6.64	5.46	7.88	7.27
TOTAL EQUITY CAPITAL	7.72	7.85	7.87	7.38	5.86	5.88	7.88	8.13
CORE DEPOSITS	9.09	7.44	7.69	11.54	8.02	6.59	9.46	9.25
VOLATILE LIABILITIES	-5.25	6.95	20.71	-0.26	1.55	-20.01	-2.72	-4.57
% NON-CURRENT LOANS & LEASES								
TOTAL LNS & LEASES-90+ DAY P/D	0.64	0.81	0.90	1.27		0.96	0.68	0.48
-NONACCRUAL	0.86	1.02	0.98	0.95		1.00	0.82	0.86
-TOTAL	1.59	1.90	1.91	2.18		2.41	1.53	1.42

*REFER TO THE UBPR USERS GUIDE FOR PRIMARY CAPITAL DEFINITION.

In our prepared testimony we noted that the approach embodied in S. 1886, based on the fragmentation of responsibility among different regulatory agencies, is not adequate to address this problem. The agency responsible for overseeing the securities affiliate, the Securities and Exchange Commission, will not be privy to information regarding the quality of loans in the bank's portfolio. It is thus unlikely that either the SEC or investors would learn the true nature of the underlying loans until a default was actually experienced. The banking agency responsible for regulating the bank will have no reason to use its authority to prevent the bank from selling low quality loans since, by doing so, the bank will actually have improved its balance sheet. Indeed, the federal banking agencies have made it clear that they are relatively unconcerned about transactions which benefit banks at the expense of their non-banking affiliates. The FDIC recently declared "Generally speaking, the potential for abuse of an affiliate to benefit the bank is of less concern than the reverse situation because there are fewer safety-and-soundness issues surrounding most nonbanking firms." (Mandate for Change: Restructuring the Banking Industry, October 1987, at 49). That this relaxed and distorted view of conflicts of interest is expressed by a bank regulator holds alarming implications for investor protection in the deregulated environment contemplated by the pending legislation.

As set forth in our prepared testimony, one possible solution to the problem of fragmented regulation would be the establishment of a single regulatory authority, or in the alternative the creation of an intra-agency council with a mandate to coordinate examination and regulatory responsibilities and to make certain that no regulatory gaps develop. We note that E. Gerald Corrigan, President of the Federal Reserve Bank of New York, offered similar suggestions when he testified before the Committee on December 10, 1987.

a. The first question posed is whether those securities firms which have mortgage lending affiliates could be subject to the same "enormous incentive" to dispose of their low quality loans through a securities affiliate engaged in mortgage-backed securities underwriting.

While the record demonstrates that commercial banks have in fact engaged in this very type of abusive practice in the past and may be inclined to do so again if the Glass-Steagall Act is repealed, we are not aware of any evidence that securities firms with mortgage lending affiliates are engaging in this type of practice or intend to do so in the future. This apparent difference in behavior between commercial banks with securities affiliates and securities firms with mortgage lending affiliates may be attributable to several factors. First, as exemplified by Mr. Huertas' statement, banking organizations tend to concentrate first and foremost on the financial well-being of the bank; there is no evidence that securities firms with mortgage-lending affiliates make their first priority the well-being of those affiliates. Similarly, as exemplified by the FDIC's statement, bank regulators are solely concerned with the safety and soundness of the bank, and might even be inclined to encourage a bank to rid itself of low quality loans through public underwritings conducted by the bank's securities affiliate. Finally, and possibly the most important consideration involves the unique public faith and trust in banks. Large segments of the public will accept without question low quality loans sold by bank securities affiliates under the express or implied imprimatur of the bank name and general reputation of banks for exercizing prudence in the origination of loans. Loans sold by securities firms do not carry the same imprimatur.

b. The second question asks whether we would recommend that securities firms which have mortgage lending affiliates divest of these activities on the grounds of conflict of interest. In view of the differences between the public perception of banks and other commercial ventures we question whether such divestiture is called for in the absence of evidence of significant abuses. Moreover, as a practical matter, there is a vast difference in the amounts of mortgage loans held by depository institutions versus those held by affiliates of securities firms.

As of June 1987, mortgages held by depository institutions totaled $1,373 billion, whereas mortgages held by finance companies, including those associated with securitis firms, totaled only $67.8 billion.

c. The third question asks for a list of the largest 25 mutual fund complexes and for each of the 25 a list of the corporate affiliates of the mutual fund.

The following is a list of the largest 25 mutual fund complexes as of October 31, 1987:

AIM Group
Alliance Capital Management
American Capital
Capital Research & Management
Colonial
Dean Witter
Dreyfus
E. F. Hutton Group
Federated
Fidelity
Franklin Group of Funds
IDS Mutual Fund Group
Institutional Liquid
Kemper
Keystone Group
Massachusetts Financial
Merrill Lynch
Oppenheimer/Centennial
PaineWebber
Prudential-Bache
Putnam Funds
SEI Financial Services
Shearson Lehman Brothers
T. Rowe Price
Vanguard Group (The)

We note that these 25 complexes contain over 976 mutual funds. Therefore, for the purpose of responding to the second part of this question, we have selected the largest mutual fund in each complex. The attached is a listing including the name of each of these 25 mutual funds and (to the extent we were able to determine) their "affiliated persons" (excluding individuals) as that term is defined in Section 2(a)(3) of the Investment Company Act of 1940 (see Attachment A).* We note that, except in a rare case, the only corporate affiliate of the fund is the fund's investment adviser.

Q. 2. If letting banks into the mutual fund business is not such a good idea, why have so many of your members been eager to get into the banking business through the nonbank bank loophole?

If the Congress follows your advice and keeps the Glass-Steagall Act on the books, how many of your members would be willing to divest themselves of their non-bank banks?

A. 2. It is our understanding that most mutual fund complexes which are members of the Institute do not own nonbank banks. Further, many of the nonbank banks which are affiliated with mutual fund organizations are in reality limited purpose trust companies (i.e., entities formed to manage pension and other fiduciary assets or to act as custodians for retirement plan assets). These limited purpose trust companies traditionally have not made commercial loans or accepted deposits from their trust customers except as incidental to their trust business. Since these limited purpose trust companies do not raise the concerns generally ascribed to nonbank banks, Congress excluded them from the nonbank bank provisions of the Competitive Equality Banking Act of 1987.

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* Section 2(a)(3) provides:

"Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

It is our understanding that most of the other nonbank banks which are affiliated with mutual fund organizations accept deposits, but do not make commercial loans. The ownership of these nonbank banks enable mutual fund organizations to meet competition from depository institutions, which have been authorized by bank regulators to offer securities services and products, including mutual fund shares, as well as deposits. As set forth on pages 9-11 of our written statement before this Committee on January 23, 1987, many of the widespread abuses that took place in connection with bank sponsorship of mutual funds in the 1920s resulted from the banks' role as commercial lenders.* As discussed above, it is our understanding that most nonbank banks which are affiliated with mutual fund organizations do not make commercial loans. Therefore, it would appear that these affiliations do not raise the same concerns as does the proposed entry of commercial banks into the mutual fund business.

We believe that the Congress is faced with a policy decision which either requires movement in the direction of a full integration of financial services, i.e., free and open competition in every aspect of the financial services business, or the restoration of the traditional Glass-Steagall demarcation between the banking business and the securities business. If Congress determines to follow this latter approach, it will be necessary to close a number of loopholes sought to be created by the bank regulatory agencies (including the Comptroller's bank IRA loophole, the FDIC's state bank loophole and the Federal Reserve Board's putative securities affiliate loophole). Absent a decision to move decisively in one direction or the other, present law should not be changed.

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* As stated in our testimony:

> "The abuses included fund investment in debentures of a troubled company which was financed by the bank; fund ourchases of illiquid loans from the bank; and fund loans to accommodate 'good customers' of the bank. In addition, there were instances in which the fund had invested in companies in order to further the bank's commercial interests -- for example, fund purchases of stock in other banks in anticipation of statewide branching; and so that the affiliated bank would be in a better position to sell correspondent services to these smaller banks. Other abuses included fund investment in stock of the bank; fund loans to the bank; its securities affiliate, bank officers and directors, and companies controlled by insiders; fund purchases of securities from the bank or its securities affiliate; fund investment in companies in which insiders had an interest; and fund purchases of securities being underwritten by the bank's securities affiliate." (Footnotes omitted)

Further, as we stated in our testimony last month, enactment of S. 1886 would create an extremely unfair competitive situation. The bill would permit all banking organizations to enter the securities business, but, by leaving Section 4 of the Bank Holding Company Act in place, would continue to preclude most of the nation's major securities firms from engaging in the banking business. This is hardly a recipe for fair competition.

Attachment A

Complex	Fund	Corporate Affiliate(s) of the Fund
American Capital	American Capital Government Securities, Inc.	American Capital Asset Management, Inc. (Investment Adviser ("IA"))
Capital Research and Management	Investment Company of America	Capital Research and Management Company (IA)
Colonial	Colonial Government Securities Plus Trust	Colonial Management Associates, Inc. (IA)
Alliance Capital Management	Alliance Capital Reserves	Alliance Capital Management Corporation (IA)
Dreyfus	Dreyfus Liquid Assets, Inc.	The Dreyfus Corporation (IA)
Federated	Trust for U.S. Treasury Obligations	The Standard Fire Insurance Corporation (IA) (no other information available)
Fidelity	Fidelity Cash Reserves	Fidelity Management & Research Corporation (IA)
Franklin Group of Funds	Franklin U.S. Government Securities Series	Franklin Advisers, Inc. (IA)
IDS Mutual Fund Group	IDS High Yield Tax-Exempt Fund	IDS Financial Corporation (IA)
Kemper	IPI Government Plus Portfolio	Kemper Financial Services, Inc.
Massachusetts Financial	MFS Lifetime-Government Securities Plus	Lifetime Advisers, Inc. (IA)
Merrill Lynch	CMA Money Fund	Fund Asset Management, Inc. (IA)

Oppenheimer/ Centennial	Daily Cash Accumulation Fund	Centennial Capital Corporation (IA)
T.Rowe Price	T. Rowe Price Cash Reserve Fund	T. Rowe Price Associates (IA)
Putnam Funds	Putnam High Income Government Trust	Putnam Management Company, Inc. (IA)
Shearson Lehman	Temporary Investment Fund	(1) Provident Institutional Management Corporation (IA) (2) Provident National Bank (sub-adviser)
Dean Witter	Dean Witter U.S. Government Securities Trust	Dean Witter Reynolds Inc.-InterCapital Division (IA)
The Vanguard Group	Windsor Fund	(1) The Vanguard Group, Inc. (the service company jointly owned by all of the Vanguard funds) (2) Wellington Management Corporation, Barrow Hanley Mewhinney & Strauss, Inc., and INVESCO Capital Management, Inc. (investment advisers to the Fund) (3) as of Nov. 30, 1987, the Fund owned more than 5% of the voting securities of the following corporations: a. ANR Corporation b. H.F. Ahmanson & Co. c. American Savings Bank d. Bankers Trust New York Corp.

		e. Cigna Corp. f. Citadel Holding Corp. g. Coast Savings & Loan h. Crossland Savings FSB i. Delta Air Lines, Inc. j. First Interstate Bancorp. k. Golden West Financial Corp. l. Home Federal S&L Ass'n (San Diego) m. Home Savings Bank (Brooklyn) n. MDC Holdings Incorporated o. Maritans Ltd. Units p. NWA, Inc. q. Ryland Group, Inc. r. San Francisco Fed. Savings & Loan s. The Travelers Corp.
AIM Group	Short-term Investment Prime Portfolio	AIM Advisors, Inc. (IA)
E.F. Hutton Group	Hutton Investment Series, Inc. Government Securities Series	Hutton Asset Management (IA) (no other information available)
Institutional Liquid	ILA Prime Obligation	Goldman Sachs & Company (IA)
PaineWebber	PaineWebber CASHFUND, Inc.	(1) PaineWebber, Incorporated (IA) (2) Mitchell Hutchins Asset Management, Inc. (sub-adviser)
Prudential-Bache	Pru-Bache Money Market Assets	(1) The Prudential Insurance Company of America (IA) (2) Prudential-Bache Securities, Inc. (distributor of fund shares and holder of more than 5% of fund shares)
SEI Financial Services	Keystone Custodian Fund, Series B-4	Keystone Custodian Funds, Inc. (fund trustee)

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
ROBERT GOOGINS

American Council of Life Insurance

Gary E. Hughes
Chief Counsel. Securities

Q. What are the specific safety and soundness risks involved in bank involvement and insurance activities, particularly agency activities?

A. Each segment of the insurance business involves its own set of risks. Broadly speaking, these risks are substantial and are, for the most part, unique. The ACLI represents life insurance companies and, consequently, our familiarity lies in the area of the risks associated with life insurance underwriting.

Underwriting life insurance is not necessarily more risky than the conduct of traditional banking business. However, the combination of banks and insurance companies would, without question, involve a pyramiding of familiar and unfamiliar risks, and this fact would hold true regardless of the corporate structure utilized. This pyramiding of risk poses a serious threat to the stability of the nation's banking system and to the safety and soundness of banks and other financial intermediaries. The consequences of financial instability, particularly in today's global markets, were brought to the fore by the events of and following "Black Monday."

The following discussion briefly outlines the various risks associated with the life insurance business (this discussion does not address health insurance, a business in which many life insurance companies participate, although it should be noted that morbidity risks are volatile, often cyclical, and highly unpredictable). A life insurance company faces three principal risks in conducting its business. These risks are customarily referred to as C-1, C-2 and C-3 and are summarized below.

C-1 The risk of loss of value of an asset because of default or some impairment of the earnings capacity or value of the property or organization underlying the asset.

C-2 The risk of inadequate pricing of insurance contracts for reasons other than those connected with C-1 and C-3 risks. Inadequate pricing can be the result of such things as random adverse fluctuations in experience, an inaccurate estimate of some element of cost, such as expenses, the frequency or severity of claims, or some other occurrence such as a disaster or an epidemic.

C-3 The risk of loss because of variations in the level of interest rates. Variations in the level of interest rates change the present value of the future stream of income from an asset in the absence of default or impairment of the earnings capacity or value of the property or organization underlying the asset. The same interest rate variations change the present value of future payments to be made with respect to insurance contracts. Finally, they also change the timing and amount of cash flows by triggering exercise of withdrawal rights under insurance contracts or options to prepay debt, thus producing further changes in the present value of assets and liabilities.

Banks and life insurance companies are not equally exposed to the C-1 risk and do not have equal experience in managing it. Life insurance company assets are longer (i.e., have a longer average time to maturity) and are of a wider variety than those of banks. From time to time, it has been suggested that banks entering the insurance business should limit their investments to those permitted for banks. This would reduce the C-1 risk to banks' current experience level, but they would then be unable to compete equally with insurers. Insurance companies over the years have discovered the need for a wider variety of investments. They are needed to support (match) the wider variety of contractual guarantees made by life insurers with respect to their life insurance and annuity products.

The C-2 risk for life insurers is substantially greater than that for banks. Life companies enter into contracts of long duration with guarantees based on company estimates of future contingent events. Future mortality rates and interest rates obviously come to mind. But insurers also guarantee implicitly and often explicitly other factors such as expense rates. In typical life insurance arrangements, the company's expenses in the first year exceed the margin for expense available during that year. These excess initial expenses must be recovered in future years if the business is to be profitable. Consequently, insurance prices also depend on rates of voluntary policyholder termination. The need to have cash available at times of demand also brings termination rates into play.

A key element in the management of C-2 risk is the use of historical data to predict how future results might emerge based on recent experience adjusted for trends. A key to success, when one assumes that past experience will repeat, is to carefully repeat the experiment. Life insurance actuaries have divided all variables into several quality categories. Companies must be able to achieve a correct distribution of these variables if results are to follow forecasts. For example, a life insurance company evaluates the mortality experience of its markets and, as long as it maintains its selection standards, it can hope to enjoy similar experience. To accomplish this, life companies have established units skilled at the selection and classification of risks. Any new entrant to the life insurance business would have difficulty achieving the market share, geographic distribution, and quality of risk needed to realize acceptable results.

Contrary to the view often expressed by bankers, the predictability of future mortality experience is not an exact science. Mortality experience cannot be expressed in constant terms, regardless of how long statistics are compiled. It is a factor affected by many things, including such major influences as epidemics, disasters and diseases that were unknown at the time policies were written. The current AIDS situation is an unfortunate but very illustrative example this latter factor. Life insurance companies are already facing billions of dollars in estimated claims liabilities for a disease that was unheard of at the time policies were issued. The full magnitude of the effect of AIDS on mortality experience and company profitability is impossible to assess at the present time.

Turning to the C-3 risk, a cursory review suggests that banks and insurers have the same exposure in this area. However, while most of the current difficulties in which banks find themselves is due to C-3 risk, life insurance company exposure is distinct and possibly greater. Life companies have a wider variety of both assets and liabilities which must be matched correctly to overcome this risk. As noted above, longer durations are involved, and, on both the asset and liability sides, insurers grant far more options to their contractholders than banks grant to their depositors.

The magnitude of the C-1 through C-3 risks for life insurance underwriting is, of course, affected by the extent to which market participants are experienced in the business. Banks have absolutely no experience in underwriting insurance products. While banks are permitted to "underwrite" and distribute credit life insurance, most banks do nothing more than arrange for its purchase through an unaffiliated life insurance company. Those banks that actually manufacture the product do not underwrite it in the sense that life insurance companies underwrite applications for life insurance policies or annuity contracts. The process of "underwriting" or "risk selection" is the process by which an insurer maintains cost equity among its insureds. This process is designed to charge each individual a premium that reflects the mortality risk to which he or she is exposed. Pricing insurance by age, sex, medical history, plan of insurance, occupation and other relevant factors requires the development of precise standards and reliance on an experienced staff of professional underwriters. Even with such a structure in place, the life insurance business has a significant degree of risk. Without it, underwriting life insurance would be extremely hazardous. Writing credit life insurance bears few similarities to writing other forms of life insurance. Because the amounts involved are quite small and the duration of coverage quite short, the particular characteristics of the individual insured are of little importance. Thus, writing credit insurance does not involve "underwriting" in the conventional sense.

We defer to insurance agent groups concerning the risks of bank involvement in insurance agency activities. However, we note in passing that substantial losses can be incurred even where entities limit their involvement in the insurance business to selling products manufactured by others. The recent experience of the brokerage community in selling single premium deferred annuity contracts aptly underscores this point.

One final note on risks to safety and soundness. It is generally acknowledged that if the financial services industry were highly integrated, regulators would be forced to shoulder a greater burden in several areas including consumer protection, conflicts of interest and affiliated transactions. Yet, past experience demonstrates that the ability of regulators to function effectively diminishes as the complexity of corporate structures and marketplace relationships increases. The Butcher banks, Baldwin-United and the effects on the recent stock market crash of internationalization and program trading are all illustrative of this phenomenon. Indeed, the Consumer Federation of America study to which you refer sets forth as its most serious reservation to bank entry into insurance the question of whether regulators will be capable of carrying out their responsibilities in an integrated financial services environment.

Q. Some of the testimony argued that the insurance industry is already competitive and needs no additional competition from banks. But a recent study by the Consumer Federation of America showed significant reductions in cost when savings banks sold life insurance. Would you comment? Why wouldn't commercial bank competition produce similar cost productions?

A. The ACLI had the opportunity to work with the Consumer Federation of America while its study on the potential results of bank entry into the insurance business was being prepared. Enclosed for your information and for inclusion in the hearing record is a copy of a memorandum we provided the CFA on this subject. This memorandum concludes that both the methodology and the statistical basis for this study are flawed in several material respects with the result that the study's conclusions are of questionable validity. The two most serious errors in the study involve its reliance on the savings bank life insurance model and its use of tremendously inflated premium figures to calculate potential cost savings.

Comparing the cost of SBLI with the cost of life insurance sold by companies with insurance agency forces is, in fact, an apples and oranges comparison. The only appropriate methodology is to compare SBLI with life insurance sold on a direct marketing basis. SBLI is, without question, a product sold on a direct response or direct marketing basis. As we note in our letter to the CFA, comparing SBLI to insurance sold through an agency force is like comparing the cost of full-service brokerage to that of discount brokerage. The two services are significantly different and, not surprisingly, so are the costs. While acknowledging the existence of life insurance companies selling on a direct response basis, the study makes no effort to compare the cost of SBLI with the cost of insurance sold by direct marketers.

The CFA study also ignores the unique regulatory and operational structure of SBLI. The SBLI regulatory system eliminates the need for participating savings banks to concern themselves with risk selection, product pricing, policy forms, actuarial expertise, mortality experience or insurance accounting. All of these functions are taken care of by the quasi-governmental entity that stands at the heart of SBLI in the three states in which it is authorized. The study makes no effort to analyze the impact on price of this "unification" function which is fundamental to SBLI.

Perhaps most significant is the fact that the aggregate premium dollar figure upon which the CFA bases its estimated cost savings is grossly inflated. This discrepancy appears to be the result of several factors. First, it appears that the CFA included property/casualty premiums in the aggregate life insurance premium figure. Second, as suggested in footnote 4 of our letter to the CFA, other inappropriate items are apparently included in that figure as well. For example, the CFA may have included $28 billion of renewal premiums and $14 billion of group, industrial and credit life premiums in its basic figure. In considering savings attributable to new entrants in the insurance business, renewal premiums are an erroneous consideration. Inclusion of group premiums is highly inappropriate, since the total "cost" of selling this line of insurance is generally less than 2%. Bankers are not likely to make the weekly rounds to collect premiums on industrial insurance, and they are already in the credit life insurance business. In sum, the premium figure upon which the CFA bases its claim of "billions" in savings is itself inflated by billions of dollars. Even accepting some of the CFA's assumptions, the ACLI was able to come up with potential annual savings of only $90 million.

Q. Please provide a complete list of the insurance companies that are affiliated with federally insured depository institutions, including nonbank banks and thrift institutions. Please provide the names of the depository institution and the parent holding company, if one exists, that owns both the insurance forum and the depository institution.

A. The ACLI does not maintain detailed information on specific affiliations between life insurance companies and depository institutions. As we stated in response to your supplemental question earlier this year, we believe that there are approximately 12 life insurance companies affiliated with nonbank banks. Several of these affiliations involve depository institutions that are nonoperating shells, and four involve limited purpose trust companies. We believe that there are currently less than a dozen affiliations between life insurance companies and thrift institutions.

American Council of Life Insurance

Gary E. Hughes
Chief Counsel, Securities

December 29, 1986

Stephen J. Brobeck
Consumer Federation of America
Suite 604
1424 Sixteenth Street, N.W.
Washington, DC 20036

Dear Steve:

We appreciate your providing us with the opportunity to review and comment on the draft CFA study entitled "The Potential Cost and Benefits of Allowing Banks to Sell Insurance: An Analysis of Policy Costs and Information Availability." In the attached memorandum, we raise various points which you and Dr. Cooper may find useful as you consider how to proceed with the study.

Not surprisingly, we do not agree with many of the document's assumptions and conclusions. On points of disagreement, we try to avoid justifying our contrary position through the recital of arguments that may be attributable to little more than differences in perspective. Rather, we endeavor to point out what we believe to be sound economic, legal or practical considerations which may have been overlooked or not thoroughly developed and, where possible, we cite empirical evidence that may not have been reviewed.

Our comments focus on three principal issues. The first, and perhaps most important, involves the relevance of the example of savings bank life insurance. Many of the author's conclusions on cost and information availability are predicated upon an analysis of SBLI. We believe that a number of important considerations were not taken into account in this analysis and call into question the validity of the conclusions drawn.

Second, we have been unable to verify either the assumptions or conclusions pertaining to the percentage and dollar savings to consumers that might be realized should banks be

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permitted to expand their insurance activities. Because readers may tend to gloss over the technical underpinnings of the report and simply look at the alleged potential for lower costs, we urge you to consider carefully the points we raise in this area.

Third, we discuss the credit insurance activities of banks and the consequent implications on tie-in sales and cost. We believe that important source materials were not considered in this context, and we provide citations to those materials.

Finally, we include a section setting forth a number of observations on other aspects of the study that we believe may be useful for your consideration.

Again, we thank you for providing us with the opportunity to comment and would be happy to discuss the draft further at your convenience.

Sincerely,

Gary E. Hughes

GEH:ltf

cc: Dr. Mark Cooper

December 24, 1986

COMMENTS OF THE
AMERICAN COUNCIL OF LIFE INSURANCE
ON THE DRAFT CFA STUDY ENTITLED
"THE POTENTIAL COSTS AND BENEFITS ALLOWING BANKS TO SELL INSURANCE: AN ANALYSIS OF POLICY COST AND INFORMATION AVAILABILITY"

Validity of Comparisons with SBLI

The study concludes that bank entry into the life insurance business may benefit consumers in the areas of cost and information availability. These conclusions appear predicated largely if not entirely on a comparison of the cost and sales practices of savings bank life insurance with those of "established insurance companies." We suggest that several important economic and practical considerations were ignored in drawing these comparisons, thereby calling into question the validity of the author's conclusions.

Cost Analysis. In analyzing the relative cost of savings bank life insurance versus other insurance products, the study does not draw any fundamental, operational distinctions between SBLI and life insurance companies generally (other than to note that the former is required by statute to provide low-cost coverage). Following a discussion of various factors, the study apparently concludes that savings banks operate with greater efficiency than life insurers, thereby enabling them to sell lower cost products. We believe the study omits two extremely important economic considerations.

First, savings banks, like other federally insured depository institutions, may have a measurable advantage over their nonbanking competitors in attracting low cost funds and in turn capitalizing nonbanking activities (e.g., insurance). Bank regulators have long acknowledged this fact. 1/ Putting aside questions of competitive fairness between banks and insurers, the effects on product price of indirect federal subsidization of bank insurance activity warrant consideration.

Second, both the regulation and operation of SBLI are totally dissimilar to that of competing life insurance companies. Central to the operation of SBLI in all states is a quasi-governmental entity or "fund." This fund performs two basic functions for all participating savings banks: it provides for the "unification" of mortality experience and it establishes and mandates uniform standards and practices for all aspects of the business.

1/ Testifying in 1984 before the Senate Banking Committee, then Treasury Secretary Donald Regan stated:

> [T]he unique status of depository institutions enables them to raise money in the private financial markets at a lower cost than most other borrowers by allowing the payment of lower explicit returns and/or by enabling them to overcome more easily the caution of potential investors in placing their funds with the institutions. These institutions should not be able to use the lower cost funds to engage directly in activities with non-depository institution competitors or to capitalize direct subsidiaries at advantageous transfer costs. Hearings on S. 2181 before the Senate Committee on Banking, Housing, and Urban Affairs, 98th Congress, 1st Sess., pt. 1 at 216 (1984).

"Unification" of mortality experience serves as a tool for pooling and distributing the mortality risks generated by participating savings banks and minimizes the risk that an individual savings bank, particularly one with a small number of policyholders, might be seriously impaired by an unexpectedly high number of death claims. Relatedly, the fund provides a mechanism for guaranteeing or reinsuring all policies issued by participating savings banks within the state.

The second important function of the fund is to establish uniform and exclusive policies, forms, prices, and procedures for all participating savings banks. Virtually the only discretion a participating savings bank has is to determine how to invest the funds held by its insurance department, and then only consistent with the investment limitations applicable to the bank itself.

In sum, the SBLI regulatory system eliminates the need of a participating savings bank to worry about risk selection, product pricing, policy forms, actuarial expertise, mortality experience or insurance accounting. Any insurance risks assumed by a participating savings bank are in turn guaranteed or reinsured by the fund.

The economic consequences of these unique aspects of SBLI, particularly as they bear on economies of scale and in turn price, may be significant. They should be evaluated before any conclusions are reached as to whether individual commercial banks can sell insurance more cheaply than individual life insurance companies.

Sales Practices. The survey of insurance agents contained in the study leads to the general observation that "the way savings banks sell life insurance differs dramatically from the selling practices of the established insurance companies." In the author's view, the practices of the former are preferable from the consumer's standpoint. We suggest that the survey design is flawed, resulting in an "apples and oranges" comparison.

There are two basic methods for distributing life insurance products, though of course there are endless variations on each theme. The first method involves the use of some form of agency system, such as the use of career agents, personal-producing general agents, debit agencies, brokerage distributors, securities dealers and others. The second method involves direct response marketing, where the only insurance agents involved are those located in the entity's headquarters. 2/ SBLI clearly falls within the direct response category, as do a number of life insurance companies that distribute their products in this manner.

2/ Insurance laws in all states require that a duly licensed agent consummate all sales of insurance. Consequently, it is incorrect to infer that the study compares banks' responses to insurance agents' responses. The responses were all from agents, but, as discussed below, the employers were different.

In order to compare in a meaningful way the responses of savings bank agents with those of agents of established insurance companies, one would have to compare SBLI with direct response life insurance companies. The methodology of the author's survey is analogous to comparing the telephone responses of bank discount brokerage personnel with the responses of full service broker/dealers. The responses will be different because the services provided are different.

The type of response one gets when telephoning an insurance agent depends in large measure on the marketing philosophy of the enterprise that employs that agent. In a nonpejorative sense, the agent of a direct marketer, be it a savings bank or an insurer, is comparable to an order-taker, who has a fixed supply of relatively standard products on the shelf and whose goal is to give the consumer whichever one he wants. Little if any attempt is made to assess a customer's insurance needs or to advise the customer on how best to accommodate those needs. Like the discount broker, the direct marketer may be an appropriate source of insurance for the individual who has already decided on a policy and simply wants information regarding specific options or price.

Contrarywise, the agent in the field is more akin to a service representative. The individual's goal is to understand a customer's needs and objectives and design a program using appropriate products to meet those needs. The field agent provides a more comprehensive service which, not surprisingly, may be more costly. 3/ For the consumer who is uncertain of his insurance needs, the full service agent may be the preferable choice over the agent affiliated with a savings bank or the agent of a direct response life insurance company. Unfortunately, the study does little to highlight these distinctions.

SBLI Regulatory Model. Putting aside for a moment the validity of the author's conclusions on the advantages attributable to SBLI, the author strongly implies that any determinable advantages may be realized in the context of general bank entry into the insurance business. Because the SBLI regulatory model is both unique and unsuitable for widescale entry into insurance by individual commercial banks, this inference can not be substantiated.

In addition to the issue of federal subsidization of bank insurance activities noted above, there are a number of regulatory problems raised by the SBLI regulatory concept. For example, the insurance department of a bank is an unincorporated life insurance company which would find it difficult, if not impossible, to satisfy the insurance licensing requirements of the states.

3/ The author points to the Pritchett and Brewster study as evidence that some direct writer life insurance companies have "extremely" low costs. Table VII-5 indicates that the expense ratio of direct writers is significantly lower than that of all other distributors of insurance, including savings banks. However, the author makes no effort to develop the implications of these factors.

Moreover, it is unlikely that insurance contracts issued by a bank insurance department would be covered by either state insurance guaranty funds or federal deposit insurance. Relatedly, bankruptcy of the bank would raise a number of serious questions concerning the status of the insurance department and its policyholders. The departmental approach is also contrary to emerging notions of functional regulation, which would suggest that bank insurance departments be regulated primarily, if not exclusively, by state insurance authorities. This is not the case with SBLI, where insurance regulators play a secondary role in the regulation of the bank's insurance operations.

If the SBLI regulatory model were revised significantly to accommodate the insurance activities of commercial banks -- as would indeed be necessary -- the author's conclusions based on the SBLI experience would be of little continuing relevance.

Estimated Savings to Consumers

As indicated above, it is unrealistic to rely on the example of SBLI as the basis for predicting cost savings should individual commercial banks enter the insurance business. Consequently, for this and other reasons noted below, the author's estimate of 10 percent cost savings is doubtful. But let us accept this figure for the moment, and also let us accept his guess that half of this savings might be passed through to the consumer.

On page 149, the study asserts that "a 5 percent overall reduction would save consumers billions of dollars." Since the author does not explain how he arrived at the "billions of dollars" figure, we attempted to check it for general reasonableness. We were not able to do so.

Premiums for new individual life insurance policies were about $18 billion in 1985. The author indicates on page 64 that insurance and banking industry sources generally agree that banks might achieve a 5 to 10 percent penetration of the market. Using the figure at the high end of the range, 10 percent, and applying it to the $18 billion premium volume, we obtain $1.8 billion, representing the estimated annual premium volume for new individual life insurance policies that would be written by banks. With the author's conjecture of a 5 percent pass-through of savings to the consumer, we obtain a savings of $90 million on the $1.8 billion of premiums. We realize that the savings figure would accumulate as policies are renewed and additional years of issue come into the picture, but we are unable to translate this $90 million figure into the author's "billion of dollars."

Perhaps an explanation for the author's highly inflated estimate is that he is working with faulty data. On page 87, he states that "127 companies for which premium income was available in Best's had a total premium income of almost $75 billion, or more than 40 percent of total premium income in the life insurance industry." This calculation implies total industry premium income of $187 billion. In contrast, the Life Insurance Fact Book published by the ACLI shows total premium receipts of $156 billion for life insurance, annuities, and health insurance. Has the author perhaps used figures which include property/casualty premiums for multiline companies like Travelers and Aetna? In any event, serious errors would be introduced by basing the estimated cost savings on premium figures that include anything other than life insurance premiums. In 1985, life insurance premiums were $60 billion of the $156 billion total cited above. 4/

On page 89, we see further evidence that there is a significant problem with the premium figures used by the author. He says that stock companies have an average annual premium income of almost $406 million. The ACLI statistics, which are based on an estimated 2,079 stock companies, show average premium receipts in 1985 of only $45 million. Similarly, the author says that mutual companies average $759 million in premium income; our data show an average of $471 million.

4/ The $60 billion represents the aforementioned $18 billion in estimated annual premium volume for new individual life insurance, plus $28 billion in renewal premiums for individual life and $14 billion in group, industrial and credit life insurance premiums. While the study does not explain the composition of the premium figures used, we presume that renewals, group, industrial and credit insurance were not included. Each of these items has unique characteristics, and none fit the analytical model the author utilizes.

An additional item we would note relates to the number of life insurance companies. On page 87, the author states that "the three surveys of price data yield 164 different companies to be included in the analysis. These companies represent approximately 15 percent of all life insurance companies." This implies that the total number of life insurance companies is just over 1,000, but our data indicate that 2,210 legal reserve companies are presently active.

Credit Insurance, Tie-ins and Overcharging

The author did not explore some sources which suggest that tie-ins and overcharging have been and continue to be a problem with regard to bank sales of credit insurance.

A principal authority in the area of credit insurance activities by banks is Washington attorney Thomas E. Wilson. Mr. Wilson has accumulated from state and federal sources a substantial record of abuses by banks in the sale of credit insurance. This record is contained in comments of the National Association of Insurance Brokers *et al* in the matter of *the Board of Governors of the Federal Reserve System's Proposed Elimination of the Rate Reduction Requirement From the Credit Life and Credit Accident and Health Insurance Underwriting Regulation*; Docket No. R-0491; January 24, 1984.

Mr. Wilson's study draws on five sets of Congressional hearings,5/ court cases,6/ insurance department studies,7/ FTC administrative proceedings8/ and a critical analysis of the Federal Reserve Board's own 1979 study of credit tie-ins.9/ Mr. Wilson's conclusions are all the more compelling because they are the result of sworn testimony and documented evidence rather than a random survey.

5/ Tie-in Sales of Credit Insurance in Connection with Small Loans and Other Transactions, Subcommittee on Antitrust and Monopoly Legislation of the Senate Committee on the Judiciary, 83rd Cong., 2d Sess. (1955); The Consumer Credit Industry (Credit Insurance), Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, 90th Cong. 1st Sess. (1967); Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency, Hearings on S. 1754 (Consumer Credit Insurance Act), 91st Cong., 1st Sess. (1969); Hearings on Credit Life Insurance, Subcommittee on Antitrust, Monopoly and Business Rights of the Senate Committee on the Judiciary, 96th Cong. 1st Sess. (1979) ("1979 Judiciary Hearings"); Hearings on the Federal Reserves Board's Tie-in Study, Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (1979) ("1979 Banking Hearings"). Analysis" by Emmett J. Vaughn, Lewis H. Goldfarb and David Pyle (1979).

6/ Applications of Commerce Bancshares, Inc., and Mercantile Bancorporation, Inc., 3-15 (Federal Reserve Board, June, 1982) (Missouri R. 3096, 3099-3111); 6 (Missouri R. 2817-28).

7/ November 4, 1983, Memorandum of Tennessee Insurance Commissioner John C. Neff to the State General Assembly on the subject of credit life insurance.

8/ Federal Trade Commission opinion in the matter of Guardian Loan Company, Inc., 88 FTC 632 (1976).

9/ "The Federal Reserve Board's Tying Study: A Critical Analysis" by Emmett J. Vaughn, Lewis Goldfarb and David Pyle (1979).

It is difficult to dismiss the notion that tie-ins are occurring in the face of internal bank memoranda explaining how coercion can be used to increase credit insurance sales, 10/ or penetration rates of 90-100% when similar insurance is available from other local sources at rates up to 40% less. 11/

The referenced materials, in addition to detailing the persistence of the tie-in problem, discuss at length the tendency of banks to market credit insurance at the highest rate permitted under state law. 12/ This raises the collateral issue of whether banks could be expected to sell other types of insurances at rates which would result in consumer savings. Considering that most banks are already involved in the sale of credit insurance, we question why the author failed to analyze the cost of this product and consider whether bank practices in the sale of general insurance products would be more likely to parallel the credit insurance experience than the SBLI experience.

10/ Thomas E. Wilson, Comments to Federal Reserve Board. Appendix 2 - Verbatim Quotations CBI Insurance Company Memoranda to Commerce Bank Chief Executive Officers.

11/ Thomas E. Wilson, Id. pp. 17-20.

12/ Thomas E. Wilson, Id. pp. 11-21.

General Observations

In the conclusions to the chapter on key economic concepts, the author does not bring in the competitive factor as one of the central concepts in analyzing bank entry into insurance. There are two considerations which indicate that such an omission may be appropriate.

First, based on the past history of financial service diversification, there is the likelihood that a significant percentage of new bank entrants into the insurance business, particularly in an underwriting capacity, would simply acquire existing insurance entities rather than attempt de novo operations. Such a process would not produce significantly more competitors but, rather, new owners of existing competitors.

Second, in an industry consisting of over 2,000 competing entities, which is characterized by ease of entry and in which the only type of business that is barred from entry is the banking business, we question whether adding banks to this competitive milieu would contribute at all to lowering consumer costs. Why then oppose their entry? We believe that the barriers to bank entry into insurance and into other types of business were erected to prevent those institutions that control the life blood of commerce, the money supply, from aggregating too much economic power and using that power to create an unfair competitive advantage.

The author's argument for permitting banks to enter the insurance business seems to be predicated in large part upon an alleged lowering of costs to consumers by eliminating the agency distribution system. Contrary to what the author implies on page 10, the agency system is still alive and well and accounts for 98 percent of life insurance sales. Relatedly, an unanswered question is what the banks would do if they were permitted to enter the life insurance business. How do we know that banks would not use agents if they had full insurance powers? It is also worth noting that many insurance companies have been experimenting with non-agency distribution systems. If they do prove to be cost-effective, they will be expanded. There is no need for bank entry to bring this about. The author also observes that because agents earn little on term insurance in relation to higher premium policies, term insurance is less likely to be offered to consumers. One might expect banks also to emphasize higher premium products, since their primary interest is in managing money.

In discussing cost comparisons on page 30, the author assumes on the basis of cost indices that the cost of savings bank life insurance is almost 30 percent less than that for all other companies. In the absence of an appropriate explanation, the reader could infer that the 30 percent applies to the policyholder's out-of-pocket premium cost. In this way, he or she could get a highly exaggerated impression of the actual savings. The 30 percent, of course, applies to the cost indices, which are usually only a small fraction of the premium for a life insurance policy.

On page 83, the author refers to a number of studies of life insurance costs that were made during the 1970's. Around 1980, there was a product revolution in the life insurance industry which made many of the conclusions in these studies obsolete. This is particularly true with respect to the author's observations about the noncompetitiveness of guaranteed-cost insurance sold by stock life insurance companies, a product which had almost vanished from the market by the mid-1980's. We were also quite surprised to see that in Table VIII-3, the author classified two of the largest mutual life insurance companies, the Metropolitan and the New York Life, as stock life insurance companies. If this misclassification has been carried through into the comparison of stock and mutual company aggregates, we would expect that there would be serious distortions in these comparisons.

The author seems to confuse property and casualty insurance company rating practices with life insurance company rating practices. On page 7 and throughout the paper, he talks about there being more competition (i.e. lower prices) in states where savings banks are allowed to sell life insurance. Since life insurance companies generally offer the same products at the same premium rates in all states, we fail to see the significance of this point. Property/casualty rates, of course, do vary from state to state for a variety of reasons, none of which can be attributed to the presence or absence of SBLI. We have particular difficulty understanding the following statement on page 100 as it relates to life insurance: "The direction of the relationships are as hypothesized. Savings banks have lower policyowner costs and the higher the percentage of states in which a company is licensed that are competitive, the lower its policyowner costs. In the New York price sample, the latter is not the case, but that was expected since the sampled prices are New York only prices, New York being a competitive state."

On page 36, the author presumes that insurance and banking profit streams are countercyclical in nature and suggests that higher profits can be achieved at lower risk if the two businesses are combined. His graph of insurance profitability seems to typify property and casualty insurers, but does not reflect the results for life insurers. The graph in Figure III-1 does not seem to show as good a fit as he suggests. If banking and insurance were combined, isn't it more likely that the availability of a larger pool of bank capital and access to the Federal Reserve discount window would cause even greater rate cutting during the property and casualty business' expansion cycle and further accentuate the severity of the "boom and bust" cycles that plague this side of the insurance business? On page 140, the author again asserts that synergy between bank profits and insurance profits indicates that the same rate of return could be achieved at a lower risk. However, he does qualify his remarks by noting that safety and soundness would be more likely to be improved by bank entry into insurance brokerage than bank entry into insurance underwriting. He also admits that the full potential for profits in insurance could carry banks to higher levels of risk.

Finally, we found that a number of conclusions were drawn which were not clear to us from the study. For example, on page 87, after noting that many of the hypothesized relationships are ambivalent, the author states that there is a clear expectation that competition, savings banks, and New York state regulation should be associated with lower expenses and policyholder costs. Perhaps the author could elaborate on the line of reasoning which led to this expectation. On page 108, he refers to the competition variable and the New York state regulation variable as lowering search costs. It is not clear from the study how they do this. On page 103, we would appreciate some elaboration as to how the author came to the conclusion stated as follows: "Thus, we find strong support for the conclusion that savings bank sale of life insurance is associated with lower policyowner costs. Not only do savings banks themselves appear to have lower policyowner costs, but our proxy for facing savings banks selling life insurance appears to lead insurance companies to offer lower policyowner cost options."

Starting on page 131 under the heading "Cost Price Comparison", the author discusses three indices that led him to conclude that "...embedded in the universal policies is an insurance cost that is two to three times as high as the insurance cost of a good term policy." We were unable to follow the line of reasoning he used to support this statement. He determines indices that he says represent what consumers would save if they purchased a particular term insurance policy, rather than a specified universal life policy. However, he fails to specify what the universal life policy is in terms of face amount, premium, and premium payment period, so that it is impossible to determine how he arrived at his conclusion.

Finally, on page 151, he concludes that there is a large potential benefit to consumers to be derived from bank entry into insurance based on the failings of the insurance industry. We would appreciate more elaboration on exactly what these "failings" are.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM NORMAN D. FLYNN

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®

Nestor R. Weigand, Jr., President
Ira Gribin, President-Elect

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January 12, 1988

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and Urban Affairs
U.S. Senate
534 Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the NATIONAL ASSOCIATION OF REALTORS®, I am pleased to submit the following response to the question posed in your December 22, 1987 letter to Norman D. Flynn, for the record of the Senate Committee on Banking, Housing and Urban Affairs' December 9, 1987 hearings on the restructuring of the financial services industry.

The letter posed the following question by Senator Garn:

> "Mr. Flynn, you state in your written submission that "it is the exclusive right and responsibility of the Congress ... to decide whether financial institutions should be permitted to engage in real estate activities." For over two hundred years this country has believed that the States have the right and the responsibility to determine appropriate activities for State chartered financial institutions. Real estate activities in particular have traditionally been viewed as an area to be regulated and controlled by State law. In fact, the moratorium provision in CEBA does not attempt to interfere with the rights of the States on this issue. How can you then argue that only Congress has the right to determine appropriate activities in real estate? Are you in favor of Congress regulating the appropriate activities of real estate brokers and agents? Should Congress establish a new Federal agency to license and examine real estate agents?"

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

As stated in our testimony, the issue of restructuring the financial services industry focuses on the question of whether real estate activities should be considered appropriate businesses for the involvement of Federally-insured financial institutions. The NATIONAL ASSOCIATION OF REALTORS® believes that real estate activities should, through legislation, be deemed inappropriate.

The thrust of Senator Garn's question concerns whether it is the proper role of Congress to involve itself with specific real estate activities that are traditionally governed by the States. However, the issue presently before the Committee concerns not the regulation of real estate activities, but the regulation of Federally-insured financial institutions. Congressional oversight of the financial system, including the proper business activities of Federally-insured financial institutions, is appropriate due to their unique and pivotal role in our economy, which has no comparison within the real estate industry.

The NATIONAL ASSOCIATION OF REALTORS® believes that a stable financial system, and confidence in that system, is essential to the economic well being of our nation. The public wants and deserves assurance that the financial services industry will be able to provide an efficient means of meeting its fiduciary responsibilities as well as provide adequate credit to businesses and the general public. It is because of this longstanding national goal that financial institutions have been granted special advantages, such as deposit insurance protection and access to credit. These unique benefits constitute a public subsidy, at the Federal level, that assures the ability of this nation's financial institutions to carry out their special role in our economy.

The NATIONAL ASSOCIATION OF REALTORS® is not arguing, as stated in Senator Garn's question, that "only Congress has the right to determine appropriate activities in real estate". In response to the Senator's specific questions, we favor neither new Federal regulation over the business activities of real estate brokers and agents, nor a Federal role for the licensing and examining of real estate agents. There exists no basis for regulation of such real estate activities as brokerage, management, and development, that are neither insured nor specially funded by the Federal government.

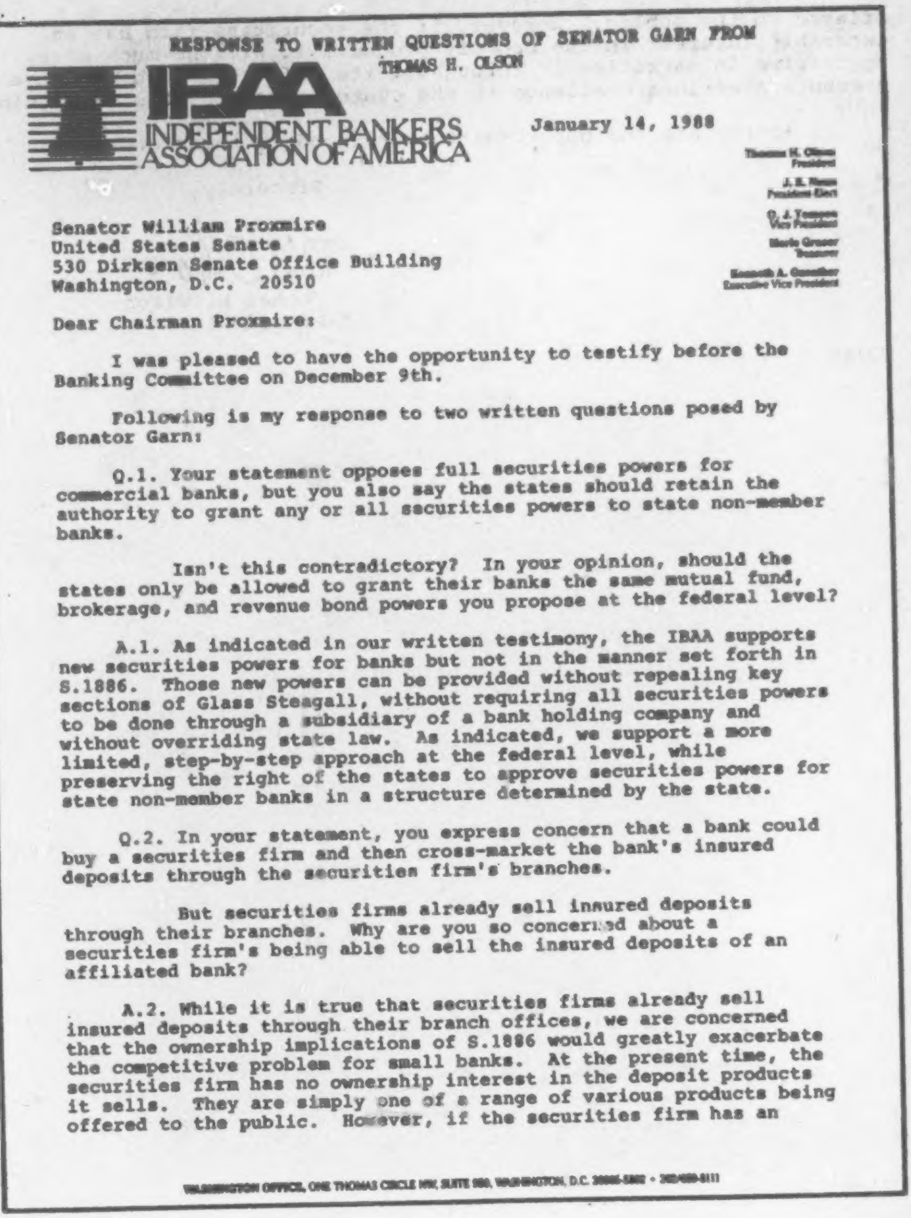
We believe, however, that Congress does have the right to determine the appropriate business activities for those financial institutions whose activities are insured by the Federal government. The NATIONAL ASSOCIATION OF REALTORS® believes strongly in this issue because the business activities of our members greatly rely on the ability of financial institutions to provide necessary services, including adequate and affordable mortgage financing. We respectfully urge the Committee to recognize that it is necessary to restrict the appropriate business activities of Federally-insured financial institutions in order to protect the Federal insurance funds, assure public confidence in the financial system, and assure the ability of financial institutions to fulfill their function.

Finally, it is important to state that a Congressional proposal to permit Federally-insured financial institutions to engage in real estate activities would expose this industry to grievous concerns as to the unfair competitive advantages that such financial institutions could possess within the real estate industry. Our written testimony details several of the specific unfair advantages that would be enjoyed by Federally-insured financial institutions permitted to engage in real estate activities. We hope that these concerns demonstrate the need for Congress to restrict Federally-insured financial institutions from participating in real estate activities.

Thank you, once again, Mr. Chairman, for the opportunity to contribute to the Committee's examination of the restructuring of the financial services industry. As always, please let us know if we may provide the Committee with any additional information.

Sincerely,

Stephen D. Driesler
Senior Vice President



RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM THOMAS H. OLSON

IBAA
INDEPENDENT BANKERS
ASSOCIATION OF AMERICA

Thomas H. Olson
President

J. R. Nease
President-Elect

D. J. Tomson
Vice President

Merle Groser
Treasurer

Kenneth A. Guenther
Executive Vice President

January 14, 1988

Senator William Proxmire
United States Senate
530 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Proxmire:

I was pleased to have the opportunity to testify before the Banking Committee on December 9th.

Following is my response to two written questions posed by Senator Garn:

Q.1. Your statement opposes full securities powers for commercial banks, but you also say the states should retain the authority to grant any or all securities powers to state non-member banks.

Isn't this contradictory? In your opinion, should the states only be allowed to grant their banks the same mutual fund, brokerage, and revenue bond powers you propose at the federal level?

A.1. As indicated in our written testimony, the IBAA supports new securities powers for banks but not in the manner set forth in S.1886. Those new powers can be provided without repealing key sections of Glass Steagall, without requiring all securities powers to be done through a subsidiary of a bank holding company and without overriding state law. As indicated, we support a more limited, step-by-step approach at the federal level, while preserving the right of the states to approve securities powers for state non-member banks in a structure determined by the state.

Q.2. In your statement, you express concern that a bank could buy a securities firm and then cross-market the bank's insured deposits through the securities firm's branches.

But securities firms already sell insured deposits through their branches. Why are you so concerned about a securities firm's being able to sell the insured deposits of an affiliated bank?

A.2. While it is true that securities firms already sell insured deposits through their branch offices, we are concerned that the ownership implications of S.1886 would greatly exacerbate the competitive problem for small banks. At the present time, the securities firm has no ownership interest in the deposit products it sells. They are simply one of a range of various products being offered to the public. However, if the securities firm has an offered to the public. However, if the securities firm has an ownership interest in the deposit product, it will be much more aggressive in marketing it throughout its offices. Such a change presents a serious challenge to the customer base of the small bank.

I appreciate the opportunity to respond to these questions.

Sincerely,

Tom Olson

Thomas H. Olson
President

TO/gk

RESPONSES BY MR. BAILEY TO SENATOR PROXMIRE PERTAINING TO DECEMBER 9, 1987 HEARING

QUESTION 1: On page 7 of your testimony, you state two concerns with S.1886:

(a) that Section 102, in permitting the sale and underwriting of securities of "any type," could allow banks into variable life insurance, variable annuities, and guaranteed interest contracts - products that technically are securities but which have been consistently treated as insurance by insurance regulatory authorities.

(b) that Section 203 of the bill would remove the present provisions of the Bank Holding Company Act that guarantees you notice on applications by bank holding companies to engage in insurance activities.

If S.1886 were re-drafted to meet your expressed concerns on these two issues would your Alliance be able to support the legislation?

ANSWER: The Alliance for Separation of Banking and Insurance would, of course, prefer to see S.1886 re-drafted in the suggested manner. The change in the proposed notice provision would assist not only insurance agents, but all members of the public who wish to participate in important decisions of the Federal Reserve Board. And the deletion from the bill of provisions that would permit the sale of insurance products would cure an apparently inadvertant defect in legislation which, I understand, to be focused solely on the interrelationship of the securities and banking industries.

The Alliance for the Separation of Banking and Insurance is not prepared, however, to support S.1886, even if re-drafted in the suggested manner. Rather, this Alliance is dedicated to working for passage of a bill that would eliminate the various loopholes that oversealous and ideologically-driven administrative agencies have inserted into the Bank Holding Company Act and the National Bank Act.

New legislation approved by this Committee should (i) close the so-called "South Dakota" loophole by applying the mandates of Section 4 of the Bank Holding Company Act to all subsidiaries of a bank holding company, (ii) prevent the Comptroller from twisting the National Bank Act in a fashion that, contrary to legislative expectations, permits national banks and bank holding companies to underwrite and sell insurance anywhere, (iii) establish in clear terms the meaning of the term "insurance" as used by Congress in Section 4(c)(8), (iv) restore the use of the "small-town" exemptions in the Bank Holding Company Act and the National Bank Act in a manner that reflects original congressional intent, and (v) guarantee that bank holding companies cannot buy "grandfather" rights to which they had no claim on the relevant grandfather dates.

RESPONSES BY MR. BAILEY TO SENATOR GARN

QUESTION 1: What are the specific safety and soundness risks involved in bank involvement in insurance activities, particularly agency activities?

ANSWER: The Bank Holding Company Act is designed to "prevent the combining under the same management of both banking and nonbanking interests." 102 Cong. Rec. S6752 (statement of Sen. Robertson). By restricting the sale of insurance by bank holding companies, the Act thus (i) prohibits banks from conditioning the approval of credit on a customer's use of the bank's (or an affiliate's) commercial services, (ii) prevents banks from gaining an unfair advantage over nonbanking businesses that try to compete with the bank's nonbanking interests, and (ii) lessens unnecessary risks to the security of the banking system.

The prohibition against the sale of insurance by bank holding companies serves each of the three purposes of the Act. First, banks are prevented from engaging in anti-consumer practices through the tieing of banking services to insurance products. Second, banks are barred from achieving an unfair monopoly. As Congressman Spence stated at the time of the Act's initial passage: "Just imagine what chance you would have if you were a small-business man in a community where the holding company controlled the bank and also a competing business. There is no doubt about what would be your ultimate fate." 101 Cong. Rec. H28021 (1955). Third, the prohibition protects the safety and soundness of the banking system by insuring integrity in bank operations, which maintains consumer confidence, by insuring that the bank's financial success cannot be built upon unfair competitive practices (and therefore cannot be threatened if and when the bank holding company is ever forced to cease such practices), and by eliminating the risk that bank holding companies will incur losses and/or liability from unsuccessful or negligent insurance activities.

QUESTION 2: Some of the testimony argued that the insurance industry is already competitive and needs no additional competition from banks. But a recent study by the Consumer Federation of America showed significant reduction in costs when savings banks sold life insurance. Would you comment? Why wouldn't commercial bank competition produce similar cost reductions?

ANSWER: This question is based on an erroneous premise. The Consumer Federation of America study did not focus generally on "savings banks [that] sold life insurance." The study focused much more narrowly on the sale by savings banks in three states of a special form of insurance known as "savings bank life insurance" (SBLI). In these three states, SBLI has been sold traditionally by mutual savings banks functioning in tandem with a special quasi-governmental entity. Any comparison between SBLI and the expected insurance activities of huge money center banks that drool at the opportunity to squeeze extra profits out of their customers would be unilluminating.

The American Council of Life Insurance, in its response to the same question posed by Senator Garn, has supplied the Committee with the "Comments of the American Council of Life Insurance On The Draft CFA Study Entitled 'The Potential Costs and Benefits Allowing Banks To Sell Insurance: An Analysis of Policy Cost and Information Availability." Those comments explain in great detail the flaws in the CFA analysis. We join in those comments.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
E. JAMES MORTON

1. Question: During his December 8, 1987 testimony, Mr. David Silver of the Investment Company Institute suggested that banks not be permitted to underwrite mortgage-backed securities. He claimed that banks would have an enormous incentive to pass on their low quality loans as securities and that they would reduce the level of energy devoted to checking credit quality when originating mortgage loans.

   (a) Do you share Mr. Silver's concern?

   (b) Does not the same problem currently exist within a nonbank financial services company such as Sears or Merrill Lynch? After all, each of them has a mortgage lending subsidiary and an investment banking operation within the same firm. Please explain your answer.

Answer: There are substantial business, economic and legal reasons why a bank originating mortgage loans must maintain the same credit standards, regardless of whether the loans will be kept in the bank's portfolio or sold in an offering underwritten by the bank or an affiliate of the bank. The need to obtain a high rating from rating agencies, the extensive required disclosures, and the fact that the bank could ultimately be forced to repurchase any low quality loans because of its representations as seller, all militate against any relaxation of credit standards. This conclusion is equally applicable to bank and other mortgage-originating subsidiaries of nonbank financial services companies and to those of bank holding companies.

It should be noted at the outset that the standards for the underwriting of residential mortgages are quite specific and well established. Contrary to the implication of Mr. Silver's question, there simply is not much room for making low-quality mortgage loans without running clearly afoul of those standards.

There are substantial disincentives against a bank deviating from customary mortgage origination standards and against an affiliated underwriter accepting substandard loans. At the time of origination, the bank will often not know whether a particular loan will be held or will be sold as part of a public offering. Moreover, banks are typically required to make extensive representations and warranties to the underwriter or purchaser as to the characteristics of their loans, which frequently include a requirement that the bank repurchase any loan which does not conform to the bank's representations and warranties or meet the standards of the rating agencies. Finally, an issuer will seek a high rating from the rating agencies, and in order to accomplish this it must satisfy the standards of the rating agencies, which include a close examination of underwriting standards and practices or of the characteristics of the loans in the issuer's loan pool.

The Federal Reserve Board, in its Order of April 30, 1987 approving the applications of Bankers Trust, Citicorp and J.P. Morgan to engage through subsidiaries in underwriting 1-4 family mortgage-backed securities (the "Bankers Trust Order"), concluded that the underwriter would have to adhere to high credit standards. The Board stated that "[b]ecause the mortgage-backed securities proposed for the [securities] subsidiaries are not directly issued or guaranteed by the federal government or government-sponsored agencies, the subsidiaries will be required to conduct a more extensive credit analysis and evaluation of issues and underlying mortgages than in underwriting bank-eligible mortgage related securities."

Even in the absence of business and economic incentives to maintain high underwriting standards, there are sufficient safeguards under existing laws and regulations to ensure that banks do not alter their underwriting standards when originating loans which may be sold in a public offering by an affiliate of the bank. Under existing federal securities law disclosure requirements, the issuer of securities backed by loans is required to disclose relevant information about the loans in a prospectus. The disclosures must describe the standards the bank has for loan origination and any deviation from such standards; any such deviation would therefore adversely affect the salability of the certificates. The Comptroller of the Currency made the same observation when considering whether banks should be allowed to package and sell mortgage-backed certificates. In a letter issued on June 16, 1987 granting approval to a national bank to issue and sell mortgage-backed certificates, the Comptroller noted that "the Bank would have difficulty marketing Certificates if the underlying mortgages were themselves unsound investments because federal laws require full disclosure of all material facts concerning the Certificates and the offering."

In addition to regulation under federal securities laws, the securities affiliate would be subject to all requirements imposed on broker-dealers, as well as to requirements imposed by the NASD and any exchange of which it is a member. For example, under Schedule E of the NASD by-laws, an offering which receives a rating of below Baa by Moody's or below Bbb by Standard & Poor's and for which no bona fide market exists as of the date of the filing of the registration statement and as of the effective date must be offered at a price no higher than that recommended by an underwriter independent of the bank.

Finally, studies of bank practices in connection with permitted underwriting activities have shown that there have not been any abuses of this nature. The Federal Reserve Board concluded in the Bankers Trust Order that "although to some extent the potential for conflicts of interest exist in connection with permissible securities and lending activities presently engaged in by member banks, there is no evidence that bank underwriting of eligible securities over the past 50 years has produced serious conflicts of interest or other abuses or encouraged imprudent lending practices. Because the proposed activities involve securities that are substantially similar to those presently underwritten and dealt in by banks, the Board believes that the potential for significant or new conflicts of interest with respect to the proposed ineligible securities would be manageable." The Comptroller of the Currency similarly concluded that if a bank underwrites residential mortgage transactions, it is not likely to have any effect on the soundness of the bank's lending practices.

For the foregoing reasons, we believe that the specter raised by Mr. Silver is unfounded.

2. Question: Mr. Robert Googins, who also appeared on December 9, 1987, testified on behalf of the American Council of Life Insurance which represents most of the life insurance companies in this country. He states on page 8 of his testimony that the ACLI is fundamentally opposed to S. 1905 and gives three pages of testimony explaining why.

Can you help us understand why your company favors S. 1905 while most life insurance companies do not? What economic or other interests account for this split?

Answer: The American Council of Life Insurance, other insurance industry trade associations and many insurance companies continue to approach the issue of financial services restructuring solely in terms of whether bank holding companies should be granted broader insurance agency and underwriting powers. That narrow focus has so far compelled the insurance industry to oppose any procompetitive initiative, whether it be S. 1905, S. 1886 or S. 1891, and to leave unacknowledged its unique regulatory and structural vulnerabilities.

John Hancock and the other insurance companies directly and indirectly affiliated with the Financial Services Council, as well as a number of other ACLI member companies, believe the insurance industry's opposition to the expansion of bank holding company powers is shortsighted and ultimately unresponsive to the central issue of the debate. John Hancock and these other insurance companies believe that the critical issue for the insurance industry has long been reciprocal access to a marketplace where the products and sercives offered have become irretrievably integrated. In that context, the ACLI's continuing support of an outdated segmented regulatory structure and its inability to address accurately the competitive issues raised by S. 1905, as evidenced by the Financial Services Council's December 14, 1987 clarifying letter to the Committee, causes growing unease among insurance companies.

Since the legislative debate has so far focused largely on Glass-Steagall reform for purportedly "political" reasons, it is premature to attach much significance to the ACLI's reflexive opposition to S. 1905. As the debate expands to deal with comprehensive financial services restructuring, we believe the insurance industry will recognize that S. 1905 is the proposal which best resolves its regulatory and structural problems and affords insurance companies true reciprocal market access.

First, S. 1905 is the only legislative proposal which does not discriminate between financial services providers based on the scope of their current activities. This is especially important to the insurance industry because it has the most pervasive consumer bank, thrift, financial and commercial affiliations found anywhere in the financial services marketplace.

Second, S. 1905 is the only legislative proposal which does not differentiate between mutual and stock insurers and thereby allows mutual life insurance companies equal access to commercial banking markets without having to undergo the multiyear process of conversion and formation of an upstream holding company. In this regard, it is significant to note that a majority of the life insurance industry's assets are held by mutual life insurance companies unable, due to the disparities in state conversion law, to freely convert to stock form and simultaneously organize upstream holding companies.

Finally, recognizing that the insurance industry's national distribution network and its traditional preference for state regulation leaves it peculiarly susceptible to crippling state affiliation, licensing and cross-marketing restraints, S. 1905 alone provides the preemptive relief the insurance industry realizes it must have to effectively compete with commercial banks and thrift institutions.

In short, once Congress commits itself to a broad restructuring premised on competitive parity for all providers, S. 1905 will enjoy the support of the insurance industry. In the interim, the problem is not S. 1905. The problem lies instead in a political strategy which casts the issue solely in terms of Glass-Steagall reform. In an irretreivably diversified marketplace, such a piecemeal approach cannot succeed.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM E. GERALD CORRIGAN

FEDERAL RESERVE BANK OF NEW YORK
NEW YORK, N.Y. 10045
AREA CODE 212 720-6173

E. GERALD CORRIGAN
PRESIDENT

In your testimony you suggest that S.1886 would be a good first step. Some have suggested that even S.1886 would be too large a first step.

Q. 1. Would you please give us your opinion of the relative merits of making the first step a four powers bill with a subsequent, phased-in repeal of Glass-Steagall rather than enacting S.1886? The four powers would be the authority to underwrite municipal revenue bonds, commercial paper, mortgage-backed securities, and mutual funds.

Q. 2. Would you rather take the four powers approach or enact S.1886?

A. 1 and 2 My strong preference is for S-1886 rather than the four powers approach. My difficulties with the four power approach include the following; first, it would preclude any meaningful reciprocal arrangements whereby integrated securities firms could acquire depositories; second, it would not, in a meaningful way, address the international disparity problem, especially in the area of corporate finance where the problem is most acute, and third; it would foster a new and unnecessary wave of regulatory tension and avoidance as firms inevitably seek to circumvent law and regulation domestically or internationally.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM E. GERALD CORRIGAN

Q.1. You obviously feel very strongly about the need for regulation of the consolidated holding company that owns financial institutions. Why couldn't this be accomplished by a joint commission of federal regulators like those described in the Wirth-Graham and Cranston-D'Amato bills? Why is there also a need to regulate the bank holding company as the Proxmire-Garn bill suggests?

A. 1. In my view, the primary role of an intra-agency commission along the broad lines contemplated by the Wirth-Graham or Cranston-D'Amato bill should be to coordinate supervisory policies among the appropriate functional regulators so as to reduce and where possible eliminate regulatory gaps and overlaps, especially among like classes of activities that cross institutional and regulatory boundaries. As such, it is my view that such a commission should not be involved in day-to-day supervisory and examination/inspection-type activities. Those activities would be performed by existing functional supervisors.

Because "banks are special," I believe that insured depositories and companies that own and control insured depositories require a higher degree of supervisory oversight than is necessary for other types of financial concerns. As I see it, the basic distinction that should be drawn in assessing the question of the degree of supervision is whether the firm in question -- or its subsidiaries -- has access to deposit insurance, the discount window and the payments system. Where that condition is present, bank holding company structure and supervisory arrangements are called for, including the present emphasis on oversight of the consolidated company as a whole.

Q.2. Your testimony pointed out the many similarities between banks and securities firms in today's markets and the systemic risk involving both. In view of your strong views on consolidated supervision, do you think that companies owning securities firms should be regulated in the same way as companies owning banks? Do you think that Congress should consider creating separations or at least "firewalls" between securities firms and commercial firms?

A. 2. For the reasons mentioned above, securities companies that do not have direct access to the safety net need not be subject to the same degree of official oversight that is associated with banks or bank holding companies. However, I do believe a case can be made that the focus of official oversight of securities companies should take more explicit account of the company as a whole than is the case under current arrangements. That is, under current arrangements much of the supervisory effort as it pertains to securities companies is directed at investor protection issues within the registered broker-dealer. That focus is wholly appropriate, but in considering systemic risk issues, it may be appropriate for the focus of supervisory oversight to be expanded so as to focus a degree of attention on the financial condition of the company as a whole.

Q.3. In your testimony, you indicated that holding company regulation need not be as extensive as bank regulation. How do you feel about differences in holding company regulation depending on the proportion of the company that's involved in banking? I am referring to the "80 percent" exception in the Proxmire-Garn bill.

A. 3. The "80 percent" exception rule embodied in S.1886 represents a reasonable approach to limiting the degree of Federal Reserve regulation of those holding companies that have a limited involvement in banking, particularly since it contains provisions permitting some supervisory oversight of such companies when necessary. For example, under the 80 percent exception rule the Federal Reserve Board would have the authority, in emergency conditions, to examine such a bank holding company and its nonbank subsidiaries to assure the safety and soundness of its affiliated banks, and would retain its authority to order the divestiture of a banking subsidiary for persistent capital deficiency. Moreover, such companies would be subject to the Bank Holding Company Act in all respects except examinations, reports and capital requirements. Thus, the 80 percent exception rule provides some relaxation without raising serious regulatory or supervisory concerns. However, we should keep in mind that under such a rule a very large securities firm could own quite a large bank. Thus, a case could be made that the 80 percent exception rule should also include a second test relating to the absolute size of the bank.

Q.4. Some people allege that S.1886 does not go far enough in providing for a "two-way street" in which securities firms could acquire banks. Do you believe S.1886 should be amended to create more of a "two way street"? If so, what suggestions would you make?

A. 4. Subject to appropriate reporting requirements and supervisory policies, I could support an approach within which a securities company could own an insured depository as a bank holding company if some small fraction of its activities did not conform to the list of approved activities for bank holding companies. There would, for example, be some precedent for a 4.9 percent exemption although a somewhat higher exemption (7.5 to 10.0 percent) might be workable.

Q.5. You state in your prepared remarks that "the international competitiveness of both U.S. banks and securities companies ... can only suffer in a world in which unnecessary restrictions on the activities of banking and financial institutions are increasingly unique to the U.S." Can you provide some concrete examples of how U.S. banking and securities firms are suffering in the international marketplace due to Glass-Steagall?

A. 5. At present, the most visible evidence of the adverse consequences of unnecessary restrictions on U.S. financial firms can be found in the corporate banking field where the development of the Euro-currency markets, the rapid spread of securitization and the now widespread trend to more "universal" banking systems abroad have worked to make foreign markets and foreign institutions more attractive providers of such services to U.S. and foreign companies alike. A case can also be made that restrictive laws and regulation in the U.S. earlier on also helped to foster the rapid growth of the London inter-bank market just as the more recent Big Bang developments are now further enhancing London's standing as an international financial center. More generally, technology in banking and finance is such that users of such services are not nearly as confined as they once were as to where they can conduct a very wide range financial transactions now including, for example, trading in U.S. government securities and U.S. equities in foreign markets.

To date, we have seen examples of U.S. banking firms establishing or enlarging their foreign offices in part to be able to perform activities abroad that they cannot perform at home. While the consequent loss of jobs, income and supervisory control has, to date, been modest, the trend is disturbing. Indeed, in the face of technological developments and changing structures and markets in other countries, a failure to modernize our domestic financial structure seems to me to carry with it the clear risk that such developments will accelerate in the future.

BANK
CAPITAL
MARKETS
ASSOCIATION

December 18, 1987

The Honorable William Proxmire
Chairman, U.S. Senate Banking Committee
United States Senate
530 Senate Dirksen Office Building
Washington, DC 20510

Attn: Patrick Mulloy

Dear Chairman Proxmire:

On behalf of the Bank Capital Markets Association, I am pleased to submit to you a statement of support concerning the Financial Modernization Act of 1987 (S. 1886) that was recently introduced by you and Senator Garn. The Association appreciates having this opportunity to have its views included in the Banking Committee record of testimony on this very important legislation. We believe that the Financial Modernization Act is excellent legislation that, if enacted by Congress, will yield substantial and immediate public benefits.

The Association wishes to commend you and Senator Garn for your unfaltering efforts in putting together such a farsighted proposal.

The BCMA is prepared to put all of its energies towards ensuring that this legislation is passed by the Senate early in 1988. We look forward to working with you in the coming months; and if we can be of any assistance to you or your staff, please do not hesitate to call on us.

Sincerely,

Rick DeCair

Richard L. DeCair
Executive Director

Enclosure

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BANK
CAPITAL
MARKETS
ASSOCIATION

STATEMENT OF THE
BANK CAPITAL MARKETS ASSOCIATION
CONCERNING THE FINANCIAL MODERNIZATION
ACT OF 1987 (S.1886)

The Bank Capital Markets Association ("BCMA") welcomes this opportunity to submit its views on the Financial Modernization Act of 1987 (S.1886). The BCMA is a trade association of 175 commercial banks and their affiliates, of all sizes and from all parts of the country, that are active in the national and international securities markets.

BCMA Supports The Bill. The BCMA supports the Financial Modernization Act because it is a good bill that will yield substantial and immediate public benefits. These benefits include:

- -- Better service and pricing for consumers and businesses;
- -- Enhancement of the safety and soundness of our nation's banking system;
- -- Removal of anachronistic barriers to competition; and
- -- A level playing field for bank holding companies and securities firms.

This Committee has had the benefit of extensive and detailed statements supporting the bill from the Board of

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Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Treasury Department. Our comments, therefore, are brief.

The Bill Would Assure Better Pricing And Service For Consumers, Businesses and Governments. Most importantly, the bill would allow bank holding companies to serve their customers better -- consumers, small and large businesses, and state and local governments.

Consumers would get better products, better prices, and better service through the enhanced competition created by the bill. Mutual fund investments, for example, are a growing part of retirement savings for many consumers, and allowing banking organizations to provide mutual fund services will assure that they are available conveniently and at the lowest cost all across the country. Similarly, the costs of home mortgages would be minimized by allowing banking organizations to underwrite and deal in mortgage-backed securities. Secondary market liquidity for these and other securities would be enhanced, to the benefit of investors and issuers.

Business customers would reap the benefit of better products, better prices, and better service too. Reduced underwriting spreads in securities underwriting would lead to lower financing costs for businesses, and thereby encourage economic growth. Allowing banking organizations to provide additional securities services will be of particular benefit to small and regional businesses, who have ready access to their commercial bankers, but who are not large enough to gather the attention (or pay the fees) of the handful of dominant investment banks.

For state and local governments increased competition for underwriting municipal revenue bonds would decrease the costs of issuance, increase the market for these bonds, and provide significant cost savings for their tax payers -- estimated to run into the hundreds of millions of dollars.

Bank holding companies already possess the experience, expertise, financial skills and acumen to provide securities services to the American public. The bill lets them do so.

The Bill Would Enhance the Safety and Soundness of Our Banking System. The BCMA is intensely concerned that the safety and soundness in our banking system be assured. In our view -- and in the unanimous view of the bank regulators -- the bill would achieve this goal.

Fed Chairman Greenspan, Comptroller Clarke and FDIC Chairman Seidman have all described in detail how the bill will increase the profitability and stability of the banking system while creating "firewalls" that will prevent any risk involved in the additional securities activities from adversely affecting the bank and the FDIC insurance fund.

The fact is that corporate securities underwriting and dealing involves only limited risk, and that banks have successfully managed securities underwriting risk in Europe (and, for government and some other securities, in the United States) for many years. Allowing bank holding companies to engage in more underwriting activities in the US would allow them to diversify and thereby reduce risk here at home.

In addition, the bill contains extensive protections to assure bank safety and soundness. Only holding companies -- not banks themselves -- would be permitted to own securities firms. Securities subsidiaries of holding companies would have to be capitalized adequately. The Federal Reserve Board and the SEC would continue their regulatory oversight. And the bill would prohibit any extensions of credit by a bank to its affiliated securities firm. Taken together, all these provisions in the bill more than adequately insulate federally-insured deposits from any securities risk.

The Bill Would Remove Anachronistic Barriers to Competition. The Financial Modernization Act would remove anachronistic barriers to competition that have concentrated our domestic capital markets in the hands of a few large broker/dealer firms.

For example, ten securities firms account for 85 percent of all stock underwriting and 90 percent of all mortgage-backed securities underwriting in the United States. The five largest underwriters of commercial paper account alone for over 90 percent of our market, and the five largest underwriters of all domestic corporate debt account for almost 70 percent of the market. And just five securities firms managed 99.9 percent of the dollar total of all underwritten asset-backed securities.

In contrast, where commercial banks compete with investment firms, the concentration levels are dramatically lower. In the bank-eligible municipal general obligation bond market, for example, the top ten firms (which include both commercial and investment banks) had only 31 percent of the market. This contrasts with the 57 percent share held by the top ten firms in the municipal revenue bond market where banks cannot compete.

Similarly, the Eurobond market -- where affiliate of US banks are allowed to compete -- is significantly less concentrated than the domestic US bond market. For example, the top five Eurobond underwriters control half as much of the market abroad as the top five US corporate debt underwriters control here.

The fundamental premise of our economic system is that competition benefits the public. Through international affiliates and subsidiaries, banks have demonstrated their ability to compete virogously, fairly, safely and in the public interest. By allowing US banking institutions to compete here, the bill would remove the existing incentive to move US jobs and business abroad.

The Bill Would Provide a Level Playing Field for Bank Holding Companies and Securities Firms. If history proves accurate, some elements of the securities industry will vociferously oppose this bill, even though the bill provides a level playing field -- a two-way street -- for bank holding companies and securities firms. Under the bill, securities firms would be permitted to own banks, just as bank holding companies could own securities firms. Fair competition and equal regulation would be assured because the federal bank regulators would supervise the bank and the SEC would supervise the securities firm. Why are some securities firms so opposed to fair competition? Is it because competition would threaten the multi-million dollar yearly incomes to which the partners and officers of the dominant securities firms have become accustomed?

Conclusion. Opening up the securities business to bank holding companies, and allowing securities firms to acquire banks, would enhance competition in both industries. Competition means better pricing and services for consumers, businesses, state and local governments. The Financial Modernization Act accomplishes this important public policy goal while asuring both the safety and soundness of the banking system and fair competition under equal regulation between securities and banking firms. The bill should be enacted promptly.

December 15, 1987

C/S/E

WRITTEN STATEMENT BY MICHAEL BECKER
FINANCIAL SERVICES PROJECT DIRECTOR, CITIZENS FOR A SOUND ECONOMY FOR THE RECORD IN CONNECTION WITH HEARINGS ON S. 1886, THE FINANCIAL MODERNIZATION ACT OF 1987

Citizens for a Sound Economy (CSE) is a 250,000-member citizens group based in Washington. We analyze public policy issues from the perspective of the individual consumer and taxpayer. Our interest in financial and banking issues is premised on the belief that the consumer perspective on these issues has for too long been lost amidst a chorus of special-interest voices.

CSE supports current efforts to allow bank holding companies to both underwrite securities and offer consumers new services, such as mutual funds. Such steps would bring additional competition to many aspects of the financial services industry, benefitting consumers and taxpayers as well as businesses. While CSE has reservations about some aspects of S. 1886, the Financial Modernization Act of 1987, represents an important step in the right direction and would help create a financial system which is both safer and more competitive.

It is not uncommon, of course, for narrower special interests to perpetuate laws which are not in the interests of either individuals or society as a whole. With respect to financial laws and regulations, the special interests have an

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additional advantage because the consumer benefits of restructuring financial laws are often subtle and poorly understood.

The consumer interest in the proposed legislation may not be readily apparent. It is perhaps difficult for the average person, who is not in the habit of issuing securities, to understand why he should care about the competitiveness of the investment banking industry. There are, however, many indirect effects of Glass-Steagall that cause individuals to pay higher prices for products, higher interest rates when they borrow, and higher taxes.

Allowing bank holding companies to underwrite securities would add competition to the underwriting business. It is widely recognized that bankers have the expertise and knowledge to compete in the underwriting business but are prevented by Glass-Steagall from doing so. Indeed, they already use this expertise where allowed: in foreign markets and for those government and municipal securities that they are allowed to underwrite.

Additional competition in the underwriting business would lead to lower fees (or "spreads") paid to investment banks to underwrite issues. These lower spreads, in turn, would mean lower costs of borrowing for those who issue securities. With underwriting spreads lower, businesses that currently issue securities would pay less for capital than they do today. The commercial paper market represents a prime example of where this could take place. Because of Glass-Steagall, five investment banks currently underwrite 90 percent of the commercial paper issued by corporations.

Other businesses, too small for Wall Street investment banks to concern themselves with, would gain access to new sources of capital because they could issue securities through bank holding companies. While regional investment banks do meet some of these needs, there seems little doubt that banks could add substantial opportunities for such businesses. Banks are, after all, the main financial advisors and conduits to the financial markets for many businesses, particularly small to medium-sized businesses. Allowing bank holding companies to provide additional securities services would give such firms greater flexibility in their borrowing. Lower costs, of course, mean that businesses could offer products to consumers at lower prices.

Taxpayers could also face lower tax burdens in the future because their municipalities would be able to borrow at lower rates. Bank holding companies currently are not allowed to underwrite municipal revenue bonds. Their participation would lower spreads, making it cheaper for municipalities to fund bond issues.

Bank holding company participation in underwriting would also greatly accelerate the current trend of securitization, benefitting consumers in several ways. First, securitization offers the prospect of lower interest rates on loans. Converting loans into securities makes for a more liquid market and one in which it is easier to diversify. Securitization attracts savings to any type of lending that can be securitized, thus putting downward pressures on interest rates. Securitization also allows borrowers to avoid the costs of reserve requirements and the higher equity costs involved with traditional bank lending.

Lenders can also offer more flexible conditions on loans that they know they can securitize. For example, mortgage-backed securities have made it easier for lenders to make fixed-rate loans, the type consumers generally prefer. Securitization makes fixed-rate mortgages easier because allows lenders to sell pools of such loans as securities to other investors. Longer-term investors, such as insurance companies, are often better able to take on the interest rate risk that such lending entails.

Another potential benefit to consumers from allowing banks greater securities powers would be banks' ability to offer mutual funds. Many consumers would find their banks the most convenient place to purchase mutual funds. Many are also more comfortable dealing with banks than with other financial institutions. Allowing banks to offer mutual funds would make mutual funds more convenient to buy and sell, provide access to such funds to many who might have otherwise have gone without, and perhaps also lead to higher returns for investors. Banks clearly have the expertise to manage such funds, as indicated by the large amount of business they do through their trust departments.

These are but a few of the benefits of reforming Glass-Steagall. However, some of the concerns which have arisen about breaking down the wall between commercial and investment banking also need to be addressed. They are the level of risk, conflicts of interest, and the solvency of the deposit insurance funds.

The charge that allowing bank holding companies to underwrite securities will increase the risk of holding companies is the most dubious. In the first place, earnings from lending and underwriting are negatively correlated. A company which did both would be able to diversify and therefore reduce its risk. Of course, the first thing one learns in a corporate finance class is that it is the correlation of different activities' risks and not the absolute risk for each activity, that matters when assessing risk. Nevertheless, this basic fact occasionally seems forgotten in popular discussions of the issue.

If anything, banks' lack of securities powers has itself led to increased risk-taking. Some of the industry's highest quality borrowers have, in recent years, turned to the commercial paper market for short-term credit. The result, in many cases, is that banks must seek riskier loans to drum up business.

There is also a fear that allowing bank holding companies to underwrite securities would lead to unresolvable conflicts of interest. However, there is no evidence from either the past or the present that this would be the case. Economic studies of the securities activities of banks before and during the Great Depression have found no evidence that improper securities activities contributed to bank failures. Note also that the relationships between banks and their securities affiliates would differ little from those which already exist today between securities firms and their "non-bank" banks or between banks and their trust departments. Little, if anything, has been reported about problems arising from these relationships.

One should also keep in mind that conflicts of interest occur in many business relationships. In a corporation, for instance, there are potential conflicts between the owners and managers and between the stockholders and bondholders. But the individuals involved have incentives to reduce the potential problems arising from the conflicts. They do so quite successfully.

The one legitimate concern that exists over allowing bank holding companies to underwrite securities is that the deposit guarantee might implicitly be extended to the new activities. However, limiting financial transactions between banks and their affiliates would probably be sufficient to prevent banks from using insured deposits to take excessive risks through affiliates.

In summary, reforming Glass-Steagall would generate substantial benefits. Individuals would have more options and lower rates on loans. Businesses would have greater flexibility and lower costs of raising capital. Local taxpayers would pay lower taxes while their chances of having to bail out the banks' deposit insurance funds would be reduced. Best of all, such benefits can be gained without increasing the risk of the financial system. Indeed, the greater possibilites for diversification would reduce the risks to the financial system.

Detroit Economic Growth Corporation

Growth

January 19, 1988

Senator William Proxmire
Chairman
Senate Banking Committee
530 Dirksen
Senate Office Building
Washington, DC 20510-4901

Dear Senator Proxmire:

The Detroit Economic Growth Corporation (DEGC), a private non-profit organization of government, business, labor and community leaders, supports the proposed amendments to the Glass-Steagall Act as proposed in Senate Bill S.1886.

Enclosed is a statement which we would like to have included in your committee hearings on the proposed bill.

Sincerely,

Kenneth E. Dobson
Vice President

KED/fmw

Enclosure

TESTIMONY
January 19, 1988

Senator Proxmire and other members of the Senate Banking Committee, my name is Kenneth E. Dobson and I am vice president of the Detroit Economic Growth Corporation (DEGC).

I am writing because the DEGC supports Glass-Steagall reform and, more specifically, Senator Proxmire's bill, S.1886, to accomplish that reform. The DEGC has reached this position through practical experience and because of our conviction that greater competition will benefit us and our counterparts in the economic development community.

Before discussing this position in more detail, however, some background on the DEGC would be helpful. The DEGC is a non-profit business and real estate development organization comprised of business government, labor and community leaders. We provide management, technical and financial assistance to businesses and real estate developers who are attempting to establish, maintain, or expand their operations in the city and who need development financing or working capital assistance. In order to facilitate the efforts of these businesses and to enhance the likelihood of their success, we have used a variety of conventional, public and public/private financing instruments. The public financing sources are derived from city, state and federal government. In addition, we have always attempted to work closely with our local banks and other private sector sources of financing. Our goal has consistently been to produce an overall good, sound, and blended - public and private sector - development financing package. With ever-tightening budgets for governments at all levels and recent changes in the U.S. tax code, the private sources have taken on an even more critical importance to Detroit and all cities.

As we have accelerated our search for new and innovative development financing tools from the private sector, the path has led us face-to-face to the Glass-Steagall Act and its current restrictions on the activities of local commercial banks or their affiliates. We know, for example, that recent changes in the U.S. Tax Code severely restricts access to tax-exempt revenue bond financing for small businesses and commercial real estate development. Liberalizing banking laws, in our opinion, would greatly increase the sources of potential capital for many purposes which are presently disallowed by TRA 86, but which were financed previously with such revenue bonds. We also know that our commercial banks, directly or through affiliates, are currently limited in their authority to underwrite municipal revenue bonds. These limitations inhibit the banks' involvement in developments which maybe supported by municipal finance sources, which oftentimes are essential in real estate development. Whether small business or municipal finance is the issue, the existing constraints imposed by the Glass-Steagall Act have narrowed the range of development financing options and dampened such initiatives.

Let me further relate our experience in three examples:

Early in the 1980's the City of Detroit and the DEGC worked closely with a local real estate development firm to convert an empty department store building into a retail mini-mall. The project involved 160,000 square feet of leasable space and a total cost of approximately $6 million. The primary source of term financing was to be a commercial mortgage supported by a UDAG grant, other public funds and owners equity. Because of our inability to attract the interest of local commercial banks in participating in the conventional mortgage financing, the package was submitted to a large insurance company, which finally rejected it due to the relatively small size of the package and the company's lack of familiarity with the Detroit market.

Had it been possible for commercial banks to underwrite bond financing for the project, both above-mentioned problems could have been solved. The bank could have considered the deal's relatively small size and still remained within its economies-of-scale. The bank would also have had the familiarity with the market and proximity to the project necessary to overcome concerns about lack of knowledge of the marketplace.

Another example of a real estate development project that would benefit from bank underwriting is an approximately 50,000 square foot, $2.5 million office development. The project has been financed, after a considerable delay, by a savings and loan association and guaranteed by a pension fund. With access to retail buyers who could buy bonds in small denominations, the developer would have access to lower-cost funds, and in a shorter period of time. The lower cost of funds would have translated into less debt service and less need for public monies. It would also have given small local investors a chance to invest in local real estate projects. To date, this access especially for minorities, is not readily available.

A third example is a housing project in downtown Detroit for which we have been struggling for almost two years to secure financing. The project entails the rehabilitation of an old hotel into a 350-unit apartment complex with garage and retail space at an approximate cost of $35 million. The inability of the local banks to underwrite tax exempt revenue bonds approved for the project adds to the delays already experienced.

Removal of the Glass-Steagall Act may thus not only reduce the cost of funds for a development, but make it more accessible for the developer, opening up new and profitable investment alternatives for local commercial real estate investors.

These examples show some of our needs and frustrations and our continuing efforts to find innovative financing solutions to Detroit's growth and development challenges. We undoubtedly share this frustration and perseverance with many other major cities, and with our urban economic development colleagues.

We also know that our efforts could be enhanced by Glass-Steagall reform. We are aware that the National League of Cities supports Glass-Steagall reform, and we know that economic development groups from other parts of the country do, as well.

The search for creative development financing options and local initiatives have been important to us as Detroit has made quantum leaps in its redevelopment in recent years. We have made great strides under the leadership of Mayor Coleman A. Young and we anticipate making even more profound progress as we continue "Moving Detroit Forward." Among efforts underway is a process and program which will help us determine how to increase Detroit's role as a regional banking center and to increase the availability of financing for economic and business development activities.

We suppport Senator Proxmire and his collegue's efforts; we support S.1886; and we welcome its early enactment. Thank you for your interest in our views.

Chairman Greenspan's Responses to Written Questions from Chairman Proxmire in Connection with the Hearing Held on December 1, 1987

1. In your November testimony before the House Banking Committee you noted that the Glass-Steagall Act does not apply to the foreign operations of U.S. banks and stated "the foreign offices of U.S. banks and their foreign subsidiaries and affiliates have been actively engaging abroad in a wide variety of securities activities. These include securities that are ineligible for banks to underwrite and deal, such as corporate debt and equity."

What are the potential consequences to our economy of the fact that U.S. banks can engage in securities operations abroad that they cannot engage in within our own country? Are jobs being lost now? Will more be lost as this trend progresses? Can we deal with the problem by forbidding our banks to engage abroad in securities activities they cannot conduct in the United States.

Answer: The ability of banking institutions to engage in securities activities abroad, in countries such as the United Kingdom and Canada, tend to encourage United States banking institutions to conduct a larger share of their financial transactions in the markets of these countries. Participation in both securities and banking markets by not only U.S. banks, but also banks in other countries, helps to broaden and deepen these markets, thereby adding to their attractiveness as places to do business. In these circumstances, it is reasonable to conclude that financial transactions will take place in London, for example, that would otherwise take place in the United States. This is particularly true in the extensive Eurobond market where U.S. banks are important participants. While impossible to measure, U.S. financial markets may already have lost job opportunities because banking institutions are not authorized to engage transactions in the United States that are permitted in other countries.

While U.S. banking institutions have been major players in the Eurobond market for more than 10 years, the recent expansion of the opportunities for banking institutions to participate fully in the securities markets in London should increase still further the presence of these institutions in these markets and this trend is likely to be extended as other countries emulate the British example as has occurred in Canada.

You also asked whether these problems can be cured by forbidding U.S. banking institutions from engaging overseas in transactions and activities which they cannot conduct in the United States. We believe that this would be self-defeating and short-sighted and would simply have the effect of transferring the business now done by U.S. institutions to foreign entities, and weaken the ability of U.S. banks to compete more generally in international financial markets. This development could, in fact, have a more general adverse impact on the competitiveness of U.S. goods and services in international markets.

2. As you know, Japan presently has its own Glass-Steagall type law separating commercial banking and investment banking. One argument for the repeal of our Glass-Steagall law is that it would make U.S. banks stronger and more competitive in their international competition with foreign banks. Are you aware of any movement in Japan to repeal its own Glass-Steagall law to make its banks more competitive internationally? If Japan acted and we did not, would that further handicap our banks in their ability to compete internationally? If you believe it would, please explain why.

Answer: In early December, a subcommittee of the Japanese Ministry of Finance's ("MoF") Financial Systems Research Council, an advisory body to the Banking Bureau at the Ministry, submitted a report that discussed possible liberalization of the strict separation between securities and banking activities now required by Article 65 of the Japanese banking law. The final report supports continuation of efforts to lower the administrative barriers between banks and securities firms by expanding the areas where they can compete on an equal footing.

To follow-up on the recommendations of the subcommittee's report, the MoF has set up working groups to look into specific proposals to reform the banking system. At this time we understand that these groups will focus on the segmentation in the banking system between commercial banks, trust banks, long-term credit banks and other small financial institutions. A working group has not yet been established to investigate reform of Article 65.

Some erosion of the separation of banking and securities activities is evident in Japan. The Banking and Securities Bureaus within the MoF have been attempting in recent months to soften the boundaries between banking and securities activities by allowing both banks and securities firms to deal in new instruments and activities as they are created, such as the recently established commercial paper market. This does not require modification of Article 65 which contains an explicit list of instruments classified as securities, so that new instruments are not covered by the Article. More recently, the MoF announced in mid-January provisional guidelines for the upcoming establishment of financial futures and options markets in Japan. The guidelines would allow banks and securities firms to participate in most of the new instruments, although certain of the new instruments are reserved exclusively for banks and others for securities firms.

We are aware that the Japanese authorities are carefully observing the debate going on in the United States concerning repeal of the Glass-Steagall Act, and we can expect that they will be importantly influenced by the result in this country.

You have asked whether, if the Japanese proceed to repeal Article 65 and we do not, that would handicap our banks in their ability to compete internationally. As I have noted in my answer to Question 1, if financial institutions can offer a wide variety of financial products, their ability to compete internationally will be enhanced. With the integration of capital markets and the existing high degree of international competition, customers will go to those institutions that are capable of providing the most innovative and flexible services at the lowest cost. Consistent with my answer to Question 1, we believe an expansion in the scope of activities in which foreign banking institutions are permitted to engage would, if similar powers are not accorded U.S. banks, adversely affect the ability of U.S. banks to serve both United States and foreign customers.

3. In April 1987, the GAO completed its study entitled Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities.

The GAO stated on page 19 of that report:

> "If a bank and its affiliate are legally separate, the affiliate's creditor will not be able to reach the bank's assets to settle claims against the affiliate, and the bank's losses would be limited to the amount invested in the affiliate. To be legally separate, therefore, the bank and its affiliate must conduct business in such a manner that the courts will recognize their independence."

Is the Federal Reserve Board satisfied that the provisions of S. 1886 will provide the legal separateness identified by GAO as a key factor in insulating banks from the risks of expanded powers?

Answer: One of the basic premises of the Federal Reserve's support for the legislation that Chairman Proxmire and Senator Garn have introduced to repeal the Glass-Steagall Act is that securities activities of banking organizations will be conducted in separate subsidiaries of a holding company in order to assure that the federal safety net for depository institutions is not impaired by the securities activities of these organizations. We agree with the GAO that to accomplish this objective, and to prevent a bank from being legally liable for the actions of its securities affiliates, "the bank and its affiliate must conduct business in such a manner that the courts will recognize their independence."

This separation can never be perfect when institutions are commonly owned. However, we believe that the arrangements adopted in S. 1886 are sufficient to achieve the goal of assuring recognition of the independence between a bank and a securities company owned by the same holding company. Crucial to the question of independence is the issue of independent financing. S. 1886 takes an important step towards assuring this independence by generally prohibiting interaffiliate credit transactions and guarantees, as well as limiting lending for the purpose of supporting securities underwritten by an affiliate. Capital adequacy is another important sign of independence, and the bill assures that securities affiliates will be separately capitalized and will be required to meet the standards applicable generally to securities firms under Securities and Exchange Commission regulations. The bill also limits officer and director interlocks and assures the adequacy of disclosure of the relationship between the bank and a securities affiliate. We believe that these safeguards are sufficient to achieve the objective of establishing independence, to the extent feasible, while still allowing banking and securities affiliates to operate in a way so as to provide efficient services to customers.

Chairman Greenspan's Responses to Written Questions From Senator Garn in Connection with the Hearing Held on December 1, 1987

1. The assertion has been made that the doctrine of "piercing the corporate veil" may result in the liability of a bank for the debts of a related securities company. Please explain in detail, including appropriate case citations, why you believe that the potential for bank liability would be greater if the bank were the parent company controlling a securities subsidiary rather than a sister company affiliated with the securities company through a common parent holding company. In this regard please assume that all required attributes of corporate separateness are maintained and that the bank is exercising the same degree of control over the related securities company in both instances. See Rose Hall, Ltd. v. Chase Manhattan Overseas Banking Corporation, 576 F. Supp. 107 (D. Del. 1983), aff'd. 740 F.2d 956 (4d Cir. 1984).

Answer: In my testimony before the Committee, I made the case that corporate separateness between the securities affiliate and the bank is essential in order to implement the new securities powers proposed in S. 1886 consistent with bank safety and soundness. The testimony makes the point that the structure that provides the most effective separation that institutional arrangements can provide between the bank and the securities affiliate would be to place these activities in a subsidiary of a bank holding company rather than in the bank or a direct subsidiary of the bank.

We do not hold the view that this is the only structure that could be used or that the conduct of securities activities in a subsidiary of a bank would necessarily result in liability on the part of the bank for the obligations of its subsidiaries. In other words, the Board believes, for the reasons set out in my testimony, that the holding company format is preferable because it takes maximum advantage of the doctrine of corporate separateness. For example, in the case of the bank-subsidiary relationship, there is a direct ownership link between the bank and its subsidiary and thus the bank has ultimate authority for the conduct of the activities of the securities affiliate. In a holding company structure, this is not the case. In a bank-subsidiary relationship losses in the subsidiary are consolidated in the accounts of the bank. Again, in contrast, this does not occur in a holding company structure.

I have attached a study prepared by Board staff that addresses many of the questions that you have raised regarding the doctrine of corporate separateness and discusses the factors that courts look to in determining whether to pierce the corporate veil, factors such as the degree of management control exerted, the extent of financial support provided, the observance of corporate formalities, and the extent of shared personnel.

While the Rose Hall case mentioned in your letter reflects a situation where the bank was not held responsible for actions of a subsidiary, there are other instances where the bank has assumed liability for the actions of another entity. The staff study analyzes the various considerations that go into a judicial determination to maintain corporate separateness. Our analysis of the law indicates that the holding company framework provides a much better vehicle for taking full advantage of the doctrine of corporate separateness.

2. As a related matter, it has been asserted that in order to protect a bank against liability under the "piercing the corporate veil" doctrine, it is necessary that there be no interlocking director or officer relationships with the securities affiliate. Please explain in detail, including case citations, whether you agree with this position, discussing in particular the case of Grandview Bank and Trust Company v. Board of Governors, 550 F.2d 415 (8th Cir. 1977). Further, please comment on whether you believe it is necessary to absolutely prohibit interlocking officer and director relationships, or whether such relationship could be permitted if a majority of the board of directors of the securities affiliate were individuals not associated with the bank or bank holding company.

Answer: As explained in the staff study mentioned in answer to the previous question, the doctrine of corporate separateness does not depend on any one factor. The existence of common officers or directors between the parent and the subsidiary is an important but not solely determinative factor.

The Grandview case referenced in your question did not involve the question of corporate liability by a bank for the actions of its subsidiary, but rather involved the issue of whether a separately incorporated bank should be viewed as a branch of another holding company bank for purposes of federal branching restrictions. In that case the bank in question was a direct subsidiary of the bank holding company (as we recommend for the securities affiliate). It was not a subsidiary of its affiliate bank.

In my testimony, I expressed the Board's support for provisions of S. 1886 which allow interlocking officers and directors between banks and securities affiliates in certain circumstances. For example, the Board supported an exemption for small banks where a majority of the directors of the securities affiliate were not also directors of the affiliated banking organization. S. 1886 also provides that the Board may grant exceptions from the prohibition on interlocking directors and officers under certain circumstances. In applying this provision, the Board would need to balance the maintenance of corporate separateness between the bank and the securities affiliate with the operating efficiencies that might be achieved through shared personnel. Based upon experience in administering the statute, it may be that interlocking arrangements could be permitted under certain situations where they would not result in increasing the risk of bank liability for the obligations of the securities affiliate.

3. Mr. Greenspan, on p. 25 of your testimony, you assert that the capital provisions of the Proxmire-Garn bill would permit unlimited leveraging by the holding company when lending to its securities affiliate. Please elaborate your views on this position, providing specific examples to support your conclusions. In doing so, please address the following questions: Why wouldn't such loans in effect be subject to the capital requirements of the securities subsidiary? Couldn't the securities affiliate itself borrow to exactly the same extent from sources other than the holding company, thereby leaving the same amount of debt in the consolidated company regardless of whether the funds were borrowed from the holding company or elsewhere? Wouldn't that be true even if the changes were made that you suggest? In fact, wouldn't the changes you suggest simply make it more expensive for a securities affiliate to borrow from its larger parent than from outside sources, thereby putting it at a competitive disadvantage vis-a-vis securities firms whose larger parent companies are unaffiliated with banks, but without resulting in any additional capital cushion to support additional assets?

Answer: As we understand it, S. 1886 provides that a holding company's equity investment in a securities affiliate would be subtracted from the holding company's capital in determining its capital adequacy and that the affiliate's capital would have to meet SEC net capital requirements. This provision is fully appropriate in that it assures the capital adequacy of the affiliate and the holding company and also protects the ability of the holding company to serve as a source of strength to its bank because the capital that it devotes to securities activities is not counted in assessing that ability.

S. 1886 is not entirely clear on the treatment of credit extended by the holding company to its securities affiliate. The Board believes it is important that funds advanced by the holding company that are treated as capital, and therefore leveraged, by the affiliate, such as subordinated debt advances by the parent to an affiliate, should be subject to prior notice and should also be deducted from the holding company's capital in determining capital adequacy.

Moreover, S. 1886 should provide that any extensions of credit by the holding company to the affiliate that are not treated as capital by the affiliate should be included in the holding company's consolidated assets in calculating the holding company's capital. If this is not done, the holding company would be able to leverage itself beyond the levels permitted for bank holding companies to provide credit support to its securities affiliate. It is important that leverage at the holding company level for whatever purpose should be subject to the minimum requirements for capital that are applicable to holding company assets generally.

You suggest, however, that such loans would be subject to the capital requirements of the securities subsidiary and that holding company capital requirements would be duplicative and unnecessary. Although the SEC establishes capital requirements for the securities affiliate, the Federal Reserve remains responsible for assuring the capital adequacy of the rest of the bank holding company. In this regard, it should be emphasized that holding company loans to the securities affiliate expose the holding company to credit risk. The Board does not believe that it would be appropriate to exempt from capital requirements loans by a bank holding company to other regulated firms simply because such firms are themselves subject to capital requirements. For example, the federal banking agencies have long required banks to hold capital against loans to or deposits with other banks. Notwithstanding the fact that the securities affiliate must meet minimum capital requirements, if the securities affiliate should experience financial difficulties it might not be able to service its own debt or service its debt to its holding company, and the holding company would then, in turn, be in a weakened position to serve as a source of strength to its bank. In fact, our experience indicates that the holding company is then likely to call upon the resources of the bank to service the debt that could no longer be serviced by its securities affiliate. We believe that requiring capital at the holding company level against loans to its securities affiliate will minimize the possibility of this occurring.

You also asked why the securities affiliate itself could not borrow to exactly the same extent from sources other than the holding company, and thus leave the same amount of debt in the consolidated company regardless of whether the funds were borrowed from the holding company or elsewhere. This is true but with two important distinctions. The first is that the holding company would not be liable for the debt, and unless it chose to come to the aid of the securities affiliate it would not be in a position to have to call on the resources of the bank in order to service the securities subsidiary's debt.

The second point is perhaps more important. The lender to the holding company parent takes into account the bank holding company ownership of a bank, and the lender may, therefore, look to the bank or the bank's income as the ultimate source of repayment should the parent itself experience financial difficulties. The market is therefore much more likely to impose stronger discipline on the borrowing of a securities affiliate than on the parent bank holding company as a pass through borrower. It is this discipline that we seek to apply to securities companies affiliated with banks. We would agree that this arrangement would deprive the securities affiliate of a part of the benefits of being affiliated with a bank. But, this seems to be both reasonable and appropriate since those benefits are derived largely from the support provided by the federal safety net for depository institutions. Any disadvantage relative to nondepository holding companies would not be significant relative to the harm that would be done by not assuring the separation and independence of a securities firm from affiliated banks to the extent feasible.

An Analysis of the Concept of Corporate Separateness in BHC Regulation from an Economic Perspective

I. Introduction

This paper proceeds from the basic assumption that certain banking functions are essential so that bank safety and soundness is critical to the smooth functioning of the economic system.[1] The issue analyzed in this study is whether bank holding company (BHC) banks are presently effectively insulated from financial problems of BHC nonbank affiliates and the parent BHC. The analysis applies to nonbank-bank holding companies (HCs) as well as traditional BHCs. The nation's largest BHCs, which operate the nation's largest banking enterprises, engage most extensively in nonbank activities. Furthermore, market forces and public policy are moving toward expanded product lines for BHCs, and nonbank-banks with very large commercial affiliates or parents have been established. Consequently, this is an important policy with implications for the future safety and financial soundness of the banking system.

In the context of BHC regulation, the legal doctrine of corporate separateness is proposed by some as a workable means of insulating bank subsidiaries from the operations of nonbank affiliates and the parent holding company.[2] The chief proponents of this view contend that the legal principle of corporate limited liability—along with supporting statutes and regulations that limit transactions between banks and their affiliates and parents—generally can be relied on to achieve corporate separateness and protect banks and their depositors from risks occurring within the corporate family but outside of bank affiliates. Those of an opposing view contend that banks cannot be effectively insulated because the investing public, large depositors, and BHC management consider all units of the BHC to be interdependent.[3] Consequently, public confidence in bank affiliates of a BHC is linked to confidence in their nonbank affiliates. In this view, the legal doctrine of corporate separateness may not offer a practical means of insulating banks from the actions of their nonbank affiliates and parent companies.

This study examines economic theory and evidence on the question of corporate separateness as it relates to BHCs. The theory is equally relevant to nonbank-bank HCs though the phenomenon is so new that there is no direct evidence on these organizations. The second, third, and fourth sections examine the way in which BHC management, the public, and the regulators, respectively, view the BHC corporate form of organization. The fifth and final section provides a summary of the issues and evidence, and states the conclusion of the study.

II. The Bank Holding Company as Viewed by Management

The perception of market participants (*i.e.*, BHC managers, and the investing and depositing public) and regulators regarding the separability of the various components of a BHC is a critical determinant of the extent to which the bank subsidiaries are insulated from the financial problems in other parts of a BHC, regardless of the effectiveness of the legal doctrine of corporate separateness. This section and the two following sections focus on how the BHC is viewed by market participants and regulators, and the economic rationale for these views. The evidence examined in these sections is generally consistent. It suggests that both market participants and regulators tend to look upon the BHC as a single corporate entity rather than as a conglomeration of separate corporate units. This section explores the views of management by focusing on management's motivations, behavior, and operating policies.

Management Motivation and Behavior

Theory and evidence outlined below suggest that whether BHC or nonbank-bank HC management is motivated by profit maximization or other objectives, there will generally be an incentive to integrate operations. This is important because while profit maximization is commonly assumed, there is good reason to question this assumption.

This paper was prepared by Anthony Cornyn, Gerald Hanweck, Stephen Rhoades, and John Rose. Rose is at Baylor University now but made his contribution to the project while employed by the Board. The views expressed herein are those of the authors and do not necessarily reflect the views of the Board or its staff.

Management Behavior Assuming the Profit Motive

It is usually taken for granted that geographic and product-line diversification increase the value of the BHC firm to shareholders—that is, that such strategies on the part of BHC management are undertaken so as to maximize BHC profits. If management believes there are economies of scale or scope, profit maximization would dictate centralized control over operations. Similarly, if BHC management believes that the overall image of the company is dependent on the financial soundness of its various parts, management may be motivated to exercise control of subsidiaries' activities and operations, and to support ailing subsidiaries. This would also reflect rational profit maximizing behavior.

Management Behavior Assuming Nonprofit Motives

Although rational profit maximizing behavior could well lead to management treating the BHC as an interdependent organization, there is reason to question the assumption of pure profit maximization. If this assumption is questioned, it is necessary to examine the likely effect of alternative management motivation on the degree of BHC integration. The economics literature has long recognized the separateness of ownership and management in large corporations and the potential for differences in the objectives of corporate managers and shareholders.[4] The history of banking since the 1930s suggests a considerable movement away from the owner-managed bank that once characterized even the largest banking firms. Today, hired managers rather than owners operate large banking organizations, and due to the dispersion of ownership through stock, owners have limited control of management. Furthermore, evidence suggests that managers have objectives other than profit maximization.[5] In particular there is some indication that managers will maximize size and diversification subject to maintaining an acceptable level of profits.

The level of management compensation is more closely tied to size than to profitability though profitability is important in determining bonuses and stock options.[6] The evidence suggests that management's compensation will increase if the firm grows and is profitable. However, management's employment, reputation, and future benefits may be adversely effected if the firm does poorly. Thus, managers have a long-run incentive to diversify the operations of their firm in order to increase firm size and to reduce employment risk[7] that may result from fluctuating earnings performance.[8] Such diversification is often accomplished by mergers.[9]

As noted, evidence suggests that BHC management may be motivated to achieve large size and some degree of BHC diversification rather than pure profit maximization. Recent BHC behavior appears consistent with the size and diversification motives. This is reflected by BHCs' active pursuit of growth and geographic diversification through domestic nonbank companies, foreign banking, nonbank subsidiaries, and interstate expansion. Furthermore, within the last five years, BHCs have been particularly active in lobbying to expand into securities activities prohibited by the Glass-Steagall Act and to conduct insurance underwriting. More recently, some large banks are expanding by opening nonbank banks and acquiring failing savings and loan associations.[10]

Like profit maximization, other objectives pursued by BHC management will have implications for the extent to which BHC operations are centralized and integrated. It seems likely that managers of large or diversified firms will seek to centralize important operations to ensure that basic management objectives are being met. The types of operations that are particularly suited to integration include funds management, advertising, data processing, EFT, legal, corporate planning, purchasing, personnel management, and accounting. Within most BHCs, the largest unit and the one with the most diverse management skills and administrative apparatus is the bank subsidiary. Thus, it appears that the organizational structure of the BHC makes the lead bank a key element in the overall operation of the BHC.

The key point that emerges from this discussion of BHC management's motivation and behavior is that whether BHC management seeks to maximize profits or other objectives, such as size and diversification, it appears that there will be an incentive to integrate operations. To the extent that such integration occurs, the lead bank, being the dominant element in the organization, will play a major role.

Management Operating Policies

As has been argued above, there appear to be incentives for BHC management to adopt policies that centralize control. In this section, a number of studies that have examined the operating policies of bank holding companies are reviewed. These studies provide evidence on the degree to which holding company managers operate their organizations as integrated units.

Studies pertaining to holding company operating policies may be conveniently divided into three groups. The first group consists of studies that are based on survey evidence of bank holding company operating practices and focuses on the degree of parent company (or lead bank) control over bank and nonbank subsidiaries. The second group of studies explores the effect of organizational centralization on the performance of multibank holding company systems. Finally, the results of several recent papers that examine the funds movement practices of bank holding companies are reviewed with regard to their implications for holding company integration.

Degree of Operating Control

Six early studies of bank holding company operating policies were reviewed in a 1978 compendium on the bank holding company movement.[11] One of the studies reviewed examined bank holding company operating policies with respect to nonbank subsidiaries while the other five focused on multibank holding company systems. Though the evidence is limited, the reviewer concluded that it suggests that bank holding companies tend to operate their organizations more like single, integrated entities than like collections of commonly owned but autonomous companies. This tendency is demonstrated by attempts bank holding companies typically make to exercise control over the management philosophy and broad operating policies of their subsidiaries. In addition, bank holding companies usually exert some direct control over specific operational areas (e.g., securities and federal funds management, budget policies, and capital management), though this practice generally seems to be less prevalent with bank subsidiaries than with nonbank subsidiaries.[12] Full integration of the holding company units appears to be partly constrained by section 23A of the Federal Reserve Act, which restricts financial transactions between a bank and its bank and nonbank affiliates.[13]

Two more recent studies of the operating policies of multibank holding companies shed further light on the integration issue. The first study, by Murray, is based on discussions with seven bank holding companies and survey responses from 16 holding companies.[14] The second study relies on survey evidence from 65 multibank holding companies located in 12 states.[15] Evidence presented in the two studies is generally consistent with that reported in the earlier works and suggests that, while the degree of centralization varies considerably across organizations, holding companies exert at least some effort to centralize and integrate the operations of their subsidiaries. Moreover, the evidence from both studies indicates that the extent of centralization within bank holding companies generally increased during the 1970s.[16] Murray offers three reasons for this trend.

> First, the recession [of the mid-1970s] caused operating problems at a number of banking institutions, so many holding companies increased internal operating and financial controls and developed standardized procedures where practical. Second, the rate of acquisition expansion slowed, so resources became available for improving the internal operating policies of holding companies. [Finally], the dramatic growth of government regulation of bank holding companies provided an added thrust toward more centralized policies, which were believed necessary in order to deal effectively with legal compliance requirements.[17]

Overall, studies of the degree of BHC centralization of operating policies are generally consistent and find that BHC management tends to centralize at least some operations. While the degree of centralization varies, it tended to increase during the 1970s.

Centralization Policy and Multibank Holding Company Performance

A number of studies have explored the relationship between multibank holding company centralization policy and holding company performance. These studies are relevant because if they indicate that BHC performance is enhanced by centralization, it would appear that there is an incentive to centralize operations. The first study, by Mayne, examined the association between the performance of individual bank subsidiaries and a holding company centralization index using a sample of 656 banks divided equally between subsidiaries of multibank holding companies and independent banks.[18] Several areas of bank performance were observed over the period 1969–72 and related to various independent variables, including holding company centralization, using multiple regression analysis. Data for the centralization index were obtained from Lawrence, who had constructed the index from the results of a 1969 survey of bank holding company operating policies.[19] Contrary to expectations, Mayne found generally no relationship between the degree of holding company centralization and subsidiary bank performance. A possible explanation, she suggested, was that "regardless of the formal internal organizational structure, identification with the group may result in informal but effectively unifying operating policies."[20] Another possible explanation is that the effects of holding company centralization on subsidiary bank performance may be observed only with a time lag. Thus, the effects may not have been evident in the 1969–72 period covered by the study when the multibank holding company movement was still in its infancy. It is also possible that the effects of centralization may be less observable at the subsidiary level than for the holding company as a whole, due to various intraorganizational effects, such as interaffiliate financial transactions.[31] Finally, it is possible that the effects of centralization at the subsidiary level may vary with the size of the bank; Mayne did not test for any interactive effect between centralization and subsidiary bank size.[32]

In recognition of the potential problems with Mayne's level of observation, Whalen regressed consolidated holding company profit performance against several indexes of centralization policy and other independent variables, using a sample of 62 multibank holding companies.[33] The centralization indexes were constructed from the results of his 1979 survey work.[34] Holding company profitability was measured alternatively by the valuation ratio and the aggregate rate of return on subsidiary bank equity, for different time periods between 1979 and 1980.[35] Regression results indicated a positive, significant relationship between holding company profitability and internal structural centralization, for all profit measures and centralization indexes. These results suggest that multibank holding company efforts to manage their subsidiary banks as a single enterprise have yielded benefits for the consolidated holding company even if performance effects of centralization are not observable at the subsidiary bank level.

More recently, Whalen has examined the effect of holding company centralization policy on the profitability of individual bank subsidiaries.[36] His analysis is based on a sample of 1,210 banks, divided equally between holding company affiliates and independent banks. Using regression analysis, he estimated a bank profit function with 1979 data. The degree of holding company centralization is captured by dummy variables and is based on the results of his survey work. In contrast to Mayne's findings, the results of this study indicate that subsidiary bank performance is affected by holding company centralization policy. Specifically, the results suggest that subsidiary banks of relatively centralized holding companies tend to record higher profits than both independent banks and subsidiaries of decentralized organizations.

Overall, findings of studies of the effects of the degree of BHC centralization on financial performance are mixed but probably suggest that centralization yields higher profits. This suggests there may be a profit incentive to centralize.

Funds Transfers Within Bank Holding Companies

A third set of studies dealing with bank holding company operating policies examines the movement of funds between different units within the holding company system. In the first study, Mayne explored interbank differences in funds transferred from subsidiary banks to the parent holding company, using a sample of 874 banks from 140 bank holding companies, and data for 1975-76.[37] Upstreamed funds included cash dividends, interest, and management and service fees paid to the parent. Using regression analysis, Mayne found the combined payment of dividends, interest, and fees by the banks to their parents to be positively influenced by both the degree of financial leverage of the parent company and the extent of diversification by the holding company into highly leveraged nonbank activities (e.g., mortgage banking, commercial and consumer finance, factoring, and leasing). She concludes that "the evidence is consistent with the premise that BHC's operate as integrated entities and that this interdependence among component firms may affect the safety and soundness of affiliated banks."[38]

The second study, also by Mayne, takes a broader look at interaffiliate cash flows by examining both upstream and downstream funds transfers between the parent company and its bank and nonbank subsidiaries.[39] Cash flows include interest and dividends from subsidiaries, management and service fees paid to the parent, and loans and advances between the parent and its subsidiaries. Mayne also examines parent company borrowing from subsidiaries. Regression analysis is used to examine the effect of various holding company characteristics on each of the different types of internal funds transfers. The sample consists of 160 bank holding companies and uses data for 1976. Mayne reports several findings consistent with a single-entity view of bank holding companies. For example, she finds that management fees from bank subsidiaries are usually higher in multibank holding companies than in one-bank holding companies, suggesting that more services for bank subsidiaries tend to be centralized in the parent in the case of multibank organizations. She also reports that long-term borrowing by the parent tends to be heaviest (1) for multibank holding companies whose smaller banks have limited access to capital markets and (2) for bank holding companies with a relatively large amount of assets in highly leveraged nonbank subsidiaries. Finally, she finds that a significant factor in determining the amount of bank lending to a parent, as well as in the amount of parent lending to nonbank subsidiaries, is the amount of holding company diversification into highly leveraged nonbank firms.

The last study to be reviewed examines financial transactons between holding company banks and their nonbank affiliates (defined to include the parent company and nonbank subsidiaries of the parent).[40] The study is broader in scope than Mayne's in that it incorporates flows of funds between holding company banks and affiliated nonbank firms. At the same time, the focus is on financial transactions only, which is narrower than that of Mayne's work. In order to determine the flow of funds associated with financial transactions between holding company banks and their nonbank affiliates, Rose and Talley compiled annual data on two major types of financial transactions—extensions of credit and transfers of assets—for 224 bank holding companies over the period 1975–80. They found a net flow of funds from the nonbank sector to the bank sector of a holding company through both types of transactions each year, with a consistently larger net flow through extensions of credit. Moreover, of the total nonbank-to-bank credit extensions, most came from the parent company, while the bulk of the bank-to-nonbank credit extensions went to nonbank subsidiaries of the parent. The authors attribute the stronger nonbank-to-bank net flow of funds associated with credit extensions to the collateral requirements imposed by section 23A of the Federal Reserve Act on bank lending to affiliated companies.[31] In any event, all three studies of intercompany transactions lead to the conclusion that BHCs are operated as integrated entities.

In summary, this discussion of management motivation and operating policies generally suggests that management will operate a BHC or nonbank-bank HC as an integrated entity. Specifically, with respect to motivation, it appears that whether managers seek profit maximization or size and diversification they have an incentive to integrate operations. Regarding operating policies, research into the existence of centralized policies has found that centralization is common, but studies of the effect of centralization on financial performance yield mixed results. Studies of the intercompany transactions of BHCs suggest that BHCs tend to be operated as interdependent units. The results of this literature are generally consistent with the argument that, in spite of the uncertain benefits for financial performance, most bank holding companies integrate the operations of their various units to some degree, within the confines of regulatory restrictions.

III. The Bank Holding Company as Viewed by Market Participants and the Public

This section discusses the approach used by financial analysts in evaluating BHCs and evidence on the perceptions of market participants and the public regarding the components of BHCs. This discussion suggests that market participants—large depositors, equity and credit analysts, and the public in general—tend to view bank holding companies as single entities. In part, this perception may be attributed to the operating policies of the holding companies themselves. Specifically, bank holding company units often have similar names, and, as noted earlier, many holding companies manage their subsidiaries as integrated entities. This perception may also reflect the fact that BHCs typically report financial data for only the consolidated entity.[32]

The Consolidated Entity as the Focus of Financial Analysis

While there is widespread agreement among financial analysts that a thorough analysis of a bank holding company should include an analysis of the major segments or units of the enterprise, this is not always possible given the available data. As a result, analysts typically limit their attention to the financial statements of the consolidated organization.[33]

This emphasis is not entirely the result of data limitations. It also reflects the widely held view, within the accounting profession, that the consolidated accounting statements of a bank holding company are more meaningful than those of the parent company or its subsidiaries. In fact, in 1959, the American Institute of Certified Public Accountants (AICPA) concluded that consolidated financial statements can be presumed to provide analysts with a clearer picture of the overall condition and operating results of a multicorporate organization than can be obtained from the financial statements of individual units of the organization.[34]

The position of the AICPA is to caution financial analysts to be wary of separate financial statements of the individual corporations in a multicorporate enterprise because of the arbitrary way in which common costs can be allocated and transfer prices can be set. Common costs are costs such as advertising and overhead that are jointly shared by two or more business units of the same enterprise, and transfer prices are prices charged for goods and services that are transferred from one unit of an enterprise to another. By manipulating the allocation of common costs and varying transfer prices, a holding company can distort the "true" financial condition and performance of a subsidiary.

The focus on consolidated statements also reflects the financial disclosure requirements of the Securities and Exchange Commission (SEC). Under the Securities Exchange Act of 1934, bank holding companies meeting certain requirements must file periodic financial reports with the SEC and adhere to extensive disclosure requirements. The requirements governing the form and content of financial statements filed with the Commission are set forth in Regulation S-X. The SEC requires bank holding companies to file consolidated financial statements. Separate financial statements for bank and nonbank subsidiaries are not required, nor are separate financial statements mandated for the parent company.[35]

The emphasis on the consolidated entity is further reflected in the financial statements that bank holding companies provide to shareholders in their annual reports. A survey of bank holding company reporting practices conducted by Peat Marwick and Mitchell & Co., a major public accounting firm, revealed that most bank holding companies do not provide separate financial statements on bank or nonbank subsidiaries in annual reports to stockholders.[36] Specifically, Peat Marwick reviewed the 1982 annual reports for the 100 largest banking organizations in the United States. The findings showed that only 5 of the 100 organizations presented any financial statements for nonbank subsidiaries. Moreover, of the 100 organizations, only 38 included balance sheets of subsidiary banks in their annual reports and only 10 included bank income statements. As these findings suggest, the reporting practices of bank holding companies make it difficult, if not impossible, for market participants to analyze the separate corporate entities that comprise a bank holding company organization.

Although only a very small number of bank holding companies disclose financial information about the bank and nonbank components of their organization in shareholders reports, individual financial statements of subsidiary banks and parent company financial statements of bank holding companies are available to the public from bank regulatory agencies. While bank holding companies provide the bank regulators with financial statements of their nonbank subsidiaries, such statements are provided on a confidential basis and are not made available to the public. The reluctance of bank holding companies to make bank and nonbank subsidiary information directly available to the public through reports to shareholders tends to preclude anything other than a single entity approach to bank holding company analysis.

Evidence on the Perceptions of Market Participants and the Public

Even though a great deal of data are available to the public on the consolidated holding company and banking subsidiaries, the evidence suggests that most attention is placed on the performance of the consolidated BHC. A study by Jacobs, Beighley, and Boyd supports the hypothesis that the investing public focuses on the consolidated bank holding company entity rather than on the individual components of the holding company.[37] In that study, the authors applied a cross-section regression model to 100 BHCs over a four year period, 1970 through 1973. From their empirical results, the authors concluded that "... investors are paying increasing attention to the consolidated financial structure of holding companies" and "... the unconsolidated leverage structure of the holding company does not appear to systematically influence share price." In addition, "... of the three major holding company components—banking affiliates, nonbanking subsidiaries and the parent company—only the financial structure of banking affiliates was found to influence investors."[38]

A study by Beighley analyzed the risk perceptions of those who hold debt in lead banks and BHCs.[39] A sample of 56 issues of 42 different banking firms from 1972 to 1974 was used; 35 issues were parent-firm obligations, while the other 21 were obligations of the lead bank. Beighley concluded that "... there is some evidence in support of the hypothesis that creditors are concerned about the financial structure of the lead (largest) banking firm in the BHC." He added that "... debtholders appear to be indifferent with regard to the location of debt in the BHC (parent firm or lead bank)."[40] This last conclusion provides support for the contention that the market is mainly concerned with the consolidated BHC, as the debtholders look to the strongest component of the holding company for ultimate protection.

The two studies discussed above suggest that holders of long-term debt and equity issues focus on BHCs or the lead bank. However, experience suggests that bank liability holders may now pay closer attention to the financial condition of nonbank subsidiaries. In the mid-1970s, Hamilton National Bank of Chattanooga was forced by the parent holding company to buy a large amount of low quality mortgages from a severely distressed mortgage banking affiliate of the holding company. These purchases far exceeded the amount permitted by law and resulted in the subsequent failure of the bank. This experience would seem to provide several reasons for holders of bank and BHC debt and equity to look beyond the condition of the BHC and the lead bank. First, these investors know that essentially the same group manages the major units of most holding companies. Consequently, it is reasonable to assume that if a nonbank unit of the holding company is so mismanaged that it fails, the affiliated bank may also be mismanaged and could be in unsatisfactory condition. Second, even if the bank's liability holders suspect that the bank is in satisfactory condition, they may not want to be subject to possible criticism by continuing to do business with an organization whose reputation has been tarnished. Third, bank liability holders may be concerned that the bank may be used in an attempt to aid troubled affiliates. Even though current statutes are designed to protect banks from abuse, bank liability holders might still be concerned because the holding company might violate these statutes in a time of crisis.

In addition to the evidence suggesting that the investing public may regard the units of a BHC as interdependent, there is both direct and indirect evidence that depositors may assume such interdependence. The most vivid direct evidence arises from the Beverly Hills Bancorp episode in 1973. Beverly Hills Bancorp, the parent of Beverly Hills National Bank, had loans to a real estate developer that were funded with sales of commercial paper. When the developer could not repay the loans, the holding company was unable to pay off its maturing commercial paper obligations. The adverse publicity that accompanied this default resulted in large-scale runs on the Beverly Hills National Bank. These runs prompted the bank supervisors to merge this previously sound bank into another California bank. The strong name identification of the bank with the holding company and the fact that the parent company had sold its commercial paper to customers of the bank undoubtedly contributed to the bank's downfall.[41]

The actions of BHC management in response to financial problems of the parent or nonbank affiliates appear to provide the market with ample reason for being concerned about the ultimate effect on the bank. In such situations, the holding company management typically tries to save the troubled affiliate by transferring sufficient resources to the affiliate to meet its obligations. There may be a variety of reasons for these managerial decisions, but the major reason appears to be avoidance of serious reputation damage to the holding company organization and its bank. There have been several instances in recent years where banking organizations have gone to great lengths to preserve their reputation in the marketplace. Perhaps the best known case involved United California Bank in 1970. In that situation, the bank voluntarily assumed responsibility for the debts of its Swiss bank subsidiary, which failed after incurring losses of nearly $40 million from unauthorized speculation in cocoa futures. Legally, the bank could have walked away from this failure, but it did not apparently out of concern over possible damage to its reputation in the marketplace.

Other examples of banking organizations taking significant steps to preserve the public's perception of their reputation and financial strength are situations involving BHC-sponsored real estate investments trusts (REITs) in the mid-1970's. In 1971, the Board ruled that bank holding companies could serve as advisors to REITs. While all REITs performed poorly during this period, unpublished evidence compiled by Board staff (based on a sample of 80 REITs) shows that, during 1974–77, bank-sponsored REITs had a higher percentage of nonearning assets than nonbank-sponsored REITs in each of those years. Most notably though, in a number of cases, the bank sponsors provided financial support to their REITs on a non-arms length basis to avoid the adverse publicity which a related REIT bankruptcy would bring. As a result, the real estate investment problems were transferred to the sponsoring bank. This support was provided even though the banks were under no legal obligation to do so.[42]

A common method by which bank sponsors provided support to their advised REIT was to acquire assets from the REIT through asset swaps or straight asset purchases. Examples of this activity involved purchases of assets from advised REITs by Wisconsin Corporation and by Chase Manhattan Bank.[43] First Wisconsin Corp. purchased assets from its advised REIT that it would not otherwise have bought, if not for its role as an advisor. First Wisconsin and the REIT entered into an agreement on June 27, 1974, whereby the Trust agreed to defer litigation against First Wisconsin Mortgage Co. (its advisor), First Wisconsin Corp., and First Wisconsin National Bank. In return, First Wisconsin Corp. agreed to purchase certain loans and to provide $5.5 million of future support involving certain losses that the Trust might realize. Chase Manhattan Bank, in 1976, agreed to purchase $160.6 million of its advised REIT's assets in order to save the REIT from bankruptcy. The funds from this purchase were used by the Trust to pay creditors. Finally, it is notable that the bank regulators may have encouraged the market's perception of BHCs as integrated entities by supporting efforts to save some REITs.

The financial assistance provided by First National Bank of Chicago to Institutional Liquid Assets (ILA) is indicative of the apparent incentive of BHC management to assist financially troubled firms that they advise even though there are no ownership ties. Specifically, in October 1980, the First National Bank of Chicago and Salomon Brothers provided financial assistance to ILA, a Chicago-based institution-only money market fund that was experiencing liquidity problems due to an unusually long asset maturity structure combined with a rise in interest rates.[44] It should be *emphasized* that ILA was not a subsidiary of either First National Bank of Chicago or Salomon Brothers. First Chicago was ILA's investment advisor, and Salomon Brothers the fund's administrator and seller. Nevertheless, both First Chicago and Salomon acted to assist ILA. The reported ILA rescue package included the purchase by Salomon from ILA of $228.5 million of securities at a price about $700,000 above market value and the return to ILA by First Chicago of $1 million of previously paid advisory fees. In addition, First Chicago and Salomon agreed to waive their usual fees for an indefinite period and Salomon Brothers agreed to purchase additional securities, at a loss, if necessary.[45]

More recent evidence regarding the perceptions of market participants and BHC management is provided by the Drysdale experience in 1982. In that case, Chase Manhattan Bank and Manufacturers Hanover, acting simply as intermediaries between Drysdale Government Securities, Inc. and a number of participants in the government securities market, agreed to make the interest payments that Drysdale was unable to make. Specifically, on May 17, 1982, Chase Manhattan informed the Federal Reserve that Drysdale did not forward $160 million in interest payments to Chase Manhattan. These payments were due to other firms that had loaned government securities to Drysdale, using Chase Manhattan as an intermediary, under repurchase agreements. The following day, Manufacturers Hanover announced that it had not received nearly $30 million in interest payments from Drysdale under the same circumstances. Market pressures built for both banks to make good on the interest payments. For a complex variety of reasons, including both considerations of legal liability and the market pressures, within days, both firms made the interest payments.

Even more recently, the First Chicago Corporation took losses on a Brazilian subsidiary that far exceeded its investment in the subsidiary. In 1985, First Chicago held a 44.5 percent ownership interest in Banco Denasa de Investiment S.A., a Brazilian investment bank which had assets of about $180 million. Banco Denasa had a sizable exposure to the financial and real estate sectors of the Brazilian economy which, according to First Chicago, had come under pressure as a result of the efforts of the Brazilian government to deal with the long-term structural problems of the economy. The downturn in those sectors led First Chicago in the first quarter of 1985 to write down virtually all of its investment in Denasa, which amounted to approximately $15 million.[46]

Denasa's condition continued to worsen into the second quarter. The majority shareholder was unable to provide additional capital support to Denasa. Consequently, to prevent a run, First Chicago decided to take over the management and control of the bank and provide the needed financial support. Although First Chicago was obligated under a special agreement to recapitalize the bank by an amount equal to its 44.5 percent interest in the bank, it decided to provide support over and above that amount. As reported in the *Wall Street Journal*, Barry F. Sullivan, the Chairman of First Chicago Corporation, said, "We believe it was important for us, as a major international bank, to stand behind Banco Denasa and that we must bear the financial consequences of such support."[47] The financial consequences were a $131.1 million loss on the $15 million investment in Banco Denasa.[48]

Another recent experience suggests that it is not possible to ensure insulation through corporate separateness because of the perceptions of BHC managers and the public. This involves the case of Republic Bancorporation and Sunbelt Bank and Trust, both of Tulsa, Oklahoma. The case involved a "run" on a bank that was triggered by the collapse of a group of nonbank companies that were formerly affiliated with the bank. On March 1, 1984, Republic Bancorporation changed its name to Sunbelt Bancorporation and its bank subsidiary, the Republic Bank and Trust Company, changed its name to Sunbelt Bank and Trust. Shortly thereafter Sunbelt Bancorporation decided to divest itself of its "nonbank" subsidiaries, Republic Financial Corporation and Republic Trust and Savings. The divestiture occurred on June 29, 1984.[49] Republic Financial and Republic Trust and Savings were sold to Republic Bancorporation, Inc., and the three entities became known as the "Republic group." All legal ties between the so-called "Republic group" and Sunbelt were severed. On September 24, 1984, Republic Bancorporation, Inc. and its two subsidiaries, Republic Trust and Savings Company and Republic Financial Corporation, filed for reorganization under chapter 11 of the Federal Bankruptcy Code. Oklahoma state banking and securities officials attributed a major cause of the reorganization to a last-ditch transfer of more than $8 million of deposits and loans from Republic Financial Corporation, a nonbank finance company, to its affiliate, Republic Trust and Savings Company. Many of the loans that were transferred were considered to be problem loans by the state bank commissioner.[50] A key point is that despite the earlier divestiture, the collapse of the Republic group triggered a "run" on the Sunbelt Bank and Trust Company even though the two companies were no longer affiliated. On October 1, only a week after the Republic bankruptcy filing, the president of Sunbelt Bank and Trust held a press conference and announced that there had been a run on the bank, which had resulted in the withdrawal of about $10 million of deposits. By mid-October the Bank's president had reported that withdrawals had grown to about $15 million, lowering the bank's deposit base to $95 million.[51] By the end of November, Sunbelt Bank and Trust Company was acquired after approval by the Federal Reserve Board.

To summarize, this section has focused on the way in which BHCs are perceived by market participants and the public. The evidence and studies show that professional financial analysts and investors concentrate on the consolidated BHC, partly due to data limitations. Past experience suggests that investors and depositors have concerns about the affiliate banks when financial problems are encountered elsewhere in the BHC. Furthermore, experience suggests that BHC management will draw on the financial resources of the bank to assist a troubled nonbank subsidiary. Taken together, this evidence and experience suggests that the BHC organization is generally perceived as an integrated entity. In this regard, it is notable that Walter Wriston has observed:

> If the National Bank Act was amended to say that everything a bank holding company can do, the national bank can do, I'd be extremely happy. It would simplify administration and would make it perfectly clear to the customers that our $7 billion of capital is behind everything that we do.

Furthermore, Wriston notes:

> For example, it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way.[32]

IV. The Bank Holding Company as Viewed by Regulators

This section examines how federal regulators, particularly the Federal Reserve Board, treat bank holding companies, *i.e.*, whether regulators treat holding companies as single entities or as collections of commonly owned but autonomous companies. The section reviews the historical evidence in three areas: (1) the manner in which regulators treat affiliated units for purposes of competitive analysis of holding company acquisitions, (2) regulatory treatment of banks and their parent holding companies for purposes of monetary policy, and (3) the development of the regulatory and supervisory apparatus for ensuring the soundness of holding company banks. The evidence indicates that, consistent with the perceptions of holding company management and the public, federal authorities generally view bank holding companies as single, integrated entities.

Bank Holding Companies and Merger Policy

As a policy matter, the Board has long considered all of a holding company's bank affiliates operating within the same local market as a single banking entity for purposes of competitive analysis.[33] The Board has taken this position even though it generally has maintained that multibank holding companies are not legally branch banks.[34] In addition, in considering bank holding company applications to acquire nonbank firms engaged in permissible activities such as mortgage banking, the Board has traditionally based its competitive analysis on the total business of the consolidated holding company in that activity in the relevant geographic market.

Other regulatory agencies and the courts have adopted a position in this matter that is similar to the Board's. For example, in commenting on proposed bank holding company acquisitions, the U.S. Department of Justice has consistently considered the holding company organization as a single entity, given a product and geographic market. The courts have regularly followed this approach as well. In addition, in reviewing mergers among affiliated banks in the same holding company, both the Comptroller of the Currency and the FDIC, along with the Federal Reserve Board, have indicated that they view such mergers as essentially corporate reorganizations having no effect on competition.[35]

Bank Holding Companies, Reserve Requirements, and Deposit Rate Ceilings

While federal law and regulation generally treat sister bank subsidiaries within a multibank holding company system as separate units for purposes of reserve requirements,[36] the Federal Reserve Board has traditionally viewed the bank and nonbank sectors of a holding company organization as a single entity for such purposes. The Board first employed the single-entity view of bank holding companies in a regulatory matter relating to monetary policy in 1970. Prior to that time, the proceeds from bank holding company commercial paper issues could be downstreamed to either bank or nonbank subsidiaries without being subject to reserve requirements. Beginning in 1970, however, the Board made any such proceeds obtained by member banks fully subject to Regulation D, pursuant to authority granted to the Board the previous year.[37] The objective of this policy was to preclude banks from using the holding company structure as a vehicle for raising nonreservable funds. By imposing Regulation D on such funds, the Board made clear that it intended ". . . to maintain the effectiveness of the reserve requirement" and ". . . to put instruments of this kind [*i.e.*, bank-related commercial paper] on a more equal footing with negotiable CD's issued by banks."[38] The effect of the Board's action was subsequently determined to have reduced bank use of bank holding company downstreamed commercial paper funds by 39 percent during the first two months following the policy change.[39] Over a longer period (1970–77), the proportion of bank holding company commercial paper proceeds downstreamed to bank subsidiaries dropped from 99 percent to less than 5 percent.[40]

In the early 1970s, several large holding companies began to issue small-denomination, floating-rate thrift notes in order to circumvent Regulation Q restrictions. The Congress, in 1974, authorized the regulators to limit interest rates on holding company debt obligations (other than commercial paper) that could serve as substitutes for consumer deposits issued by depository institutions, regardless of the intended use of the proceeds of the debt.[81]

In 1977, the Board recognized another avenue by which BHCs could be used to evade reserve requirements. That situation involved an application by a bank holding company to issue, through a nonbank subsidiary, variably denominated payments instruments (essentially, traveler's checks).[82] (Variably denominated payments instruments are fully reservable if issued by a commercial bank but are reserve-free if issued by a nonbank institution.) The Board, however, was concerned that such instruments, if nonreservable, could potentially have an adverse effect on the reserve base due to the erosion of the reservable deposits of the banking system. The Board approved the application on competitive grounds. However, to minimize the potentially adverse effect on the reserve base, it imposed a $1,000 maximum face value on such instruments.[83] Recently, in response to another bank holding company application, the Board increased the maximum face value on such instruments to $10,000. In so doing, however, the Board made clear that it would closely monitor the effects of the proposal and might later impose reserve requirements if it appeared that the proposal was reducing significantly the reserve base or otherwise adversely affecting the conduct of monetary policy.[84]

Bank Holding Companies and Bank Supervisory Policy

Historically, the bank regulatory and supervisory apparatus has focused on the financial soundness of individual *banks* in order to protect the stability of the banking system and to safeguard bank depositors. While this continues to be the primary focus of public policy, the scope of regulatory and supervisory concern has expanded over time to give greater attention to the soundness of the entire holding company organization. The history of this apparatus can be roughly divided into three periods: 1933–1972, 1973–1979, and 1980–present.[85]

1933–1972

Concern with affiliation between banks and nonbank affiliates was expressed initially in 1933 when the Congress enacted section 23A of the Federal Reserve Act. Section 23A was designed to shield bank resources from abuse by placing quantitative limitations on bank transactions with affiliates and by requiring that bank loans and extensions of credit to affiliates be fully secured.[86] As stated by a Senate committee,

> The loan relationship as it exists between the bank and its affiliate differs from that prevailing with the general run of the bank's customers in an essential respect. When dealing with its affiliate, the bank is really dealing with itself, in view of the identity of ownership and management that is established. As a result there tends to be a breakdown of those limitations on the extension of credit which the bank sets up in other cases to guard against the making of excessive or poorly-secured loans.[87]

When Congress enacted the Bank Holding Company Act of 1956, it specifically addressed the issue of bank transactions with holding company units. Its decision, codified in section 6 of the Act, was to *prohibit* intrasystem investments and extensions of credit by banks in holding company systems. The only exemption to this prohibition pertained to certain noninterest-bearing deposit transactions between sister bank subsidiaries. As indicated by Congressional committee reports, the purpose of section 6 was to prevent "unsound banking practices" and to preclude the parent company from taking "undue advantage of the resources of its subsidiary banks."[88]

However, the 1966 amendments to the Bank Holding Company Act repealed the section 6 prohibition and substituted for it a provision whereby a holding company bank became subject to section 23A's limitations on transactions with its parent company and other subsidiaries of the parent. In addition, the purchase of loans on a nonrecourse basis from an affiliated bank (along with certain noninterest-bearing deposit transactions) was exempted from the restrictions of section 23A. This exemption was recommended by the Board on the grounds that both banks in any transaction would be under the supervision and examination of the bank supervisory authorities and that such transactions would allow bank portfolio adjustments in response to changes in deposits and loan demand, in effect permitting more integrated operations of multibank holding company systems without a substantial increase in risk to the banks involved.[89]

Further evidence of Congressional concern with the integrated nature of the bank holding company organization is seen in section 3(c) of the Bank Holding Company Act of 1956. That section directed the Federal Reserve Board, in judging bank acquisitions by holding companies, to consider, among other things, "(1) the financial history and condition of the company or companies and the banks involved, (2) their prospects, [and] (3) the character of their management." The 1966 Amendments to the Act changed the language of this section but maintained the intent by directing the Board to consider in every bank acquisition case

". . . the financial and managerial resources and future prospects of the company or companies and the banks concerned."[69]

Beginning in 1972, the Federal Reserve Board required each bank holding company to submit financial statements for the consolidated organization, the parent holding company, and all nonbank subsidiaries of the parent.[70] At the same time, the Board began to articulate a policy that holding companies should be a "source of financial and managerial strength" to their subsidiary banks. As it noted in August 1972, "The Board believes it is essential that bank holding companies and their nonbank subsidiaries be soundly financed so that they will, if anything, be in a position to add to the strength of their affiliated banks and in no way dilute or 'trade on' that banking strength."[71] Finally, in the same year, the Board recommended that section 23A be extended to cover some additional types of transactions, including "some purchases of assets by banks from affiliates, sales by banks to affiliates, or fees or other charges paid to affiliates," in order to prevent misuse of bank resources.[72] These actions by the Board in the early 1970s reflected an emerging belief that the financial soundness of holding company subsidiary banks is closely linked to the financial condition of the rest of the holding company system, thereby necessitating at least some regulatory oversight of the entire holding company organization.

1973–1979

Prudential regulation of bank holding companies increased substantially during the period 1973–79.[73] This development may be attributed to the general financial strains of the mid-1970s coupled with a growing concern among regulators that financial problems in the nonbank sector of a bank holding company can adversely affect subsidiary banks through either adverse transactions or reputation damage.

In 1976, section 23A came under formal review by the banking committees of the Congress and the federal bank supervisory authorities. This review was prompted by the discovery that several relatively large banks had been adversely affected by transactions with their affiliates.[74] In response, the Federal Reserve Board proposed amendments to section 23A designed, in part, to close a number of loopholes in the statute and to expand the coverage of the law to include transactions between a bank and a company that is sponsored and advised by the bank or its affiliate.[75] This latter recommendation was made in view of the experience of the mid-1970s when, in a number of cases, a financially troubled real estate investment trust received significant financial assistance from its advisory banking organization, presumably to prevent damage to the organization's reputation or to forestall lawsuits alleging that the trust received "bad" or, perhaps, even self-serving advice from the organization. The Board's proposal ultimately served as the basis for the Banking Affiliates Act of 1982, which made important, substantive changes to section 23A to limit the potential for bank abuse by affiliates.[76]

In addition to amending the law to tighten section 23A at several places, the Banking Affiliates Act liberalized the statute to facilitate greater interaffiliate financial transactions (and thus potentially increased integration of the holding company organization) where policymakers believed that such transactions would not increase significantly the risk to subsidiary bank soundness. Most notably, the amended statute (1) exempts most transactions between sister *bank* subsidiaries of a multibank holding company from the major restrictions of the law and (2) provides an expanded list of eligible collateral. The first amendment is designed to treat a multibank holding company much like a branch banking system with respect to intraorganizational funds transfers among bank affiliates; the second is intended to allow holding company banks to lend to all their major nonbank affiliates.

Federal regulators took a number of steps in 1978 and 1979, analogous to the restrictions imposed by section 23A, to protect subsidiary banks from abuse by holding company affiliates. First, in 1978, the Comptroller of the Currency criticized the practice of some national banks of paying management and other fees to holding company affiliates (and other insiders) in excess of the value of goods and services received.[77] Also, at about the same time, the Federal Reserve Board criticized intraholding company income and tax accounting transfers "that have the effect of transferring assets and income from the subsidiary banks to the parent company without offsetting benefits to the bank."[78] Finally, in 1979, the Board enumerated a number of "diversion of bank income practices" which it considered "inappropriate and, potentially unsafe and unsound."[79] The Board indicated that such practices would be subject to examiner criticism or, in cases where they are likely to have an adverse impact on the bank's condition, would be met with "formal supervisory actions (*i.e.*, written agreements and cease and desist orders) . . . to terminate the practices and require restitution or affirmative remedial action."[80]

In 1979, the Board introduced a uniform system of rating bank holding companies. This rating system, known as BOPEC, is designed to evaluate the financial condition of each of the major holding company units—*B*ank subsidiaries, *O*ther (nonbank) subsidiaries, and *P*arent company—as well as the *E*arnings and *C*apital adequacy of the consolidated organization.[81] Thus, by the end of the 1970s, the federal bank authorities clearly had in place a regulatory and supervisory apparatus that treats the bank holding company organization as an integrated unit and focuses on the financial condition of all the units of that organization, even while seeking primarily to protect subsidiary banks. This regulatory apparatus reflects the view that the actions and financial soundness of the various units of a BHC are interdependent.

1980–Present

Recent steps taken by federal regulators to coordinate their actions reflect a perception that the BHC is operated as an integrated entity.[62] In December 1979, the federal banking agencies agreed to coordinate the inspection of a bank holding company and its lead bank in all cases for holding companies with consolidated assets in excess of $10 billion and those in need of special supervisory attention and in other cases, whenever possible.[63] This agreement was expanded, in 1982, by the Federal Reserve Board and the Comptroller of the Currency to include annual, concurrent examinations of all bank holding companies with consolidated assets in excess of $1 billion and lead bank subsidiaries which were national banks.[64]

Similar coordination between the Federal Reserve and the Comptroller of the Currency is seen in the bank capital-adequacy guidelines issued jointly by the two agencies in late 1981 for national banks, state member banks, and bank holding companies that are in satisfactory financial condition.[65] The Federal Reserve made clear that, in the case of bank holding companies, the guidelines are to be applied both to individual banks in the holding company as well as to bank holding companies on a consolidated basis. The justification for this policy is that ". . . the public usually views the bank and the holding company as a single entity and links their fates."[66] The announcement of these guidelines not only demonstrated the cooperation of the two agencies in supervising bank holding companies, but also showed further their commitment to regulating bank holding companies as consolidated units.

Overall, evidence from a number of areas—competitive analysis of bank holding company acquisitions, monetary policy, and the regulatory and supervisory apparatus for ensuring the soundness of holding company banks—indicates that federal bank regulators generally view bank holding companies as single, integrated entities. With respect to competitive analysis and monetary policy, the single-entity approach has long been employed by the regulators, at least to some degree. By contrast, adoption of the single-entity view for supervisory purposes has occurred largely through an evolutionary process as regulators have observed the linkages between the financial condition of subsidiary banks and that of the rest of the holding company organization. In recognition of the existence of those linkages, the Federal Reserve Board has sought to use the vehicle of the holding company to isolate the bank as much as possible from the nonbanking activities of its holding company affiliates. This has been done in part by insisting, in considering applications to engage in nonbanking activities, that the activity be capitalized at least as well as other firms in the same industry that are unaffiliated with bank holding companies.

V. Summary and Conclusion

The legal doctrine of corporate separateness has been proposed as a means of insulating banks and their depositors from problems of nonbank BHC affiliates (including the parent company). However, a number of economists contend that the legal doctrine of corporate separateness is only one factor in determining the insulation of banks from their affiliates. They argue that the investing public, large depositors, and BHC management view the BHC as an interdependent entity. Thus, regardless of legal corporate separateness, severe problems in nonbank affiliate earnings or financial condition may be perceived by these groups as having an adverse effect on bank affiliates. This perception would arise from a belief that if an affiliate is in trouble, the bank may also have problems because they have common management and because the bank's resources may be used to bolster the troubled nonbanking operations in an effort to maintain the reputation of the BHC. For these and other reasons, it is maintained that bank insulation cannot be effectively achieved simply by enforcing the legal doctrine of corporate separateness. Accordingly, proponents of this view recommend that BHCs be regulated as integrated entities.

Theory, evidence, and regulatory policy appear to be consistent with the inseparability view of the BHC. An analysis of BHC management motives and available evidence indicates that funds do flow among BHC affiliates and that BHC management is generally inclined to support ailing nonbank affiliates by using available resources—including those of bank affiliates. In many cases, the justification for supporting ailing affiliates is to maintain the credibility and reputation of the BHC and banking affiliates. BHC management perception may be correct because additional evidence suggests that large depositors, bank and BHC bondholders and stockholders, and securities rating firms and analysts tolerate problems in one part of the company for a time but, if unresolved, they act as if they believe the entire organization could be in difficulty. It is also notable that the bank regulators have, on occasion, assisted banks that have experienced problems with their REITs and other affiliates. Such action may have encouraged the view that the BHC is an integrated entity. Finally, BHC regulatory policy has been consistent with the perceptions of BHC management and market participants. For example, limitations have been imposed on bank affiliate exposure to nonbank affiliates via section 23A of the Federal Reserve Act to insulate banking affiliates from problems in the parent and nonbank affiliates. It is notable that this analysis applies with equal force to traditional BHCs as well as nonbank-bank HCs (which own depository institutions with commercial bank charters and FDIC insurance).

In sum, it appears that BHC management, market participants, and regulators view the fortunes of a BHC subsidiary bank as linked with the BHC and nonbank subsidiaries of the BHC. The conclusion which emerges from this study is that the legal doctrine of corporate separateness is not the only factor involved in insulating BHC banks from the financial problems that may be en countered by its nonbank affiliates or the parent BHC. *Regardless* of the effectiveness of the legal concept of corporate separateness as an insulator, evidence suggests that today BHC management, regulators, and market participants (*i.e.*, the investing and depositing public) perceive the entire BHC organization as a financially interdependent entity. Consequently, it seems likely that the financial problems of a parent BHC and/or its nonbank affiliates would affect the financial position of affiliated banks. This conclusion and the fact that market forces and public policy are moving in the direction of expanded product lines for BHCs has implications for the direction that should be taken in regulating bank holding companies including the extent of product line expansion that should be allowed. It is emphasized that this conclusion is not based on an evaluation of the potential for designing legislation and regulation so as to make corporate separateness an effective vehicle for insulating banks. Rather it is an evaluation of the effectiveness of corporate separateness as it works today.

The policy issue of bank separateness has been muted by the fact that most nonbank assets of BHCs have been in activities very closely related to banking and, for most BHCs, nonbank assets have accounted for less than 5 per cent of the total. If, however, BHCs were permitted to enter the activities now being debated by public policymakers, they would be moving farther away from traditional banking activities and the percentage of BHC assets in nonbanking would be likely to increase. Similarly, the problem would be exacerbated to the extent that nonbank-banks (with commercial bank charters and deposit insurance) are allowed, because they may be owned by commercial enterprises in which case the commercial activity is likely to account for a large percentage of the entire organization. Because of the very uncertain implications for bank risk, this prospect makes bank separateness a fundamental issue in considering the direction of BHC regulation in the future—perhaps the near future.

Footnotes

1. This view has been elaborated at length by E. Gerald Corrigan, "Are Banks Special?" *Annual Report, 1982* (Federal Reserve Bank of Minneapolis), pp. 1–18 and Paul A. Volcker, Statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 13, 1983. A similar but more general view is presented by a former member of the Securities and Exchange Commission, Bevis Longstreth, "In Search of A Safety Net for the Financial Services Industry," *Bankers Magazine* (July/August 1983), pp. 27–34. An opposing view is presented by James L. Pierce, "An Essay on the Expansion of Banking Powers," Ch. 2 in Ingo Walter, ed., *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market* (New York: John Wiley and Sons, 1985), and Anthony Saunders, "An Economic Perspective on Bank Uniqueness and Corporate Securities Activities," mimeo (New York University, May 1984), though Saunder's questioning of the uniqueness of banks is considerably more cautious and less sweeping than Pierce's.

2. Samuel Chase and Donn L. Waage, "Corporate Separateness As A Tool of Bank Regulation," Samuel Chase & Company, for the American Bankers Association, October 1983; and Golembe Associates, Inc., "Product Expansion by Bank Holding Companies," prepared for the Association of Bank Holding Companies, January 1982, p. 27.

3. Statement by Robert A. Eisenbeis, Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, 97th Cong., 2nd Sess. (GPO, 1982), pp. 70–84; and George A. Kaufman, Edward J. Kane, and Paul M. Horvitz, Statements Before the Committee on Banking, Housing and Urban Affairs, 98th Cong., 1st Sess. (GPO, 1983), Part II, pp. 893–954.

4. Adolf Berle and Gardner Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932); Herbert Simon, "Theories of Decisionmaking in Economics and Behavioral Science," *American Economic Review*, 49 (June 1959), pp. 253–83; R. M. Cyert and J. G. March, *A Behavioral Theory of the Firm* (Englewood Cliffs, NJ: Prentice Hall, 1963); and M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Cost, and Ownership Structure," *Journal of Financial Economics* (October 1976), pp. 305–60.

5. There is some evidence in banking of this difference in objectives. See C. Glassman and S. A. Rhoades, "Owner vs. Manager Control Effects on Bank Performance," *Review of Economics and Statistics* (May 1980), pp. 263–70.

6. For interesting insights and a large number of references to this literature, see F. M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago: Rand McNally Publishing Company, 1980), pp. 34–41.

7. J. L. Treynor and F. Black, "Corporate Investment Decisions," in S. C. Meyers, ed., *Modern Development in Financial Management* (New York: Praeger Publishers, 1976), and Y. Amihud and B. Lev, "Risk Reduction as a Managerial Motive for Conglomerate Mergers," *Bell Journal of Economics*, vol. 12, No. 2, (Autumn 1981), pp. 605–17.

8. For example, Jensen and Meckling view management's desire to reduce their risk through the firm in terms of agency cost. They note that "If under bankruptcy the shareholders have the right to fire the management, the management will have some incentives to avoid taking actions which increase the probability of this event (even if it is in the best interest of the equity holders) if they (the management) are earning rents or if they have human capital specialized to the firm or if they face larger adjustment costs in finding new employment." Jensen and Meckling, *op. cit.*, p. 352.

9. A number of studies has concluded that mergers in banking as well as in other industries do not generally result in as great a firm value as would be expected from the union and some found that the stockholders of the acquired firms gain from the acquisition while stockholders of the acquiring firm lose. For example, see G. J. Benston, "Conglomerate Mergers: Causes, Consequences and Remedies," Working Paper No. 7914 (Graduate School of Management, University of Rochester, September 1979); M. Firth, "Takeovers, Shareholder Returns and the Theory of the Firm," *Quarterly Journal of Economics* (March 1980), pp. 235–60; T. R. Piper, "The Economics of Bank Acquisitions by Registered Bank Holding Companies," Research Report No. 48 (Federal Reserve Bank of Boston, March 1971), pp. 254–63; and D. C. Mueller, *et. al.*, *The Determinants and Effects of Mergers: An International Comparison* (Cambridge, Massachusetts: Oelgeschlager, Gunn & Hain, Publishers, Inc., 1980), pp. 308, 312–314.

10. See the statement by C. T. Conover, Comptroller of Currency, on establishing a moratorium on nonbank banks, Office of the Comptroller of the Currency, May 9, 1984. Presently, there are applications before the bank regulators for 334 nonbank charters.

11. John T. Rose, "Bank Holding Companies as Operational Single Entities," *The Bank Holding Company Movement to 1978: A Compendium* (Federal Reserve Board, 1978), pp. 69–93.

12. The issue of centralized control in one operational area—funds management—is examined in some detail in Jarratt Robert Devereux, "Central Management of Funds in a Regional Multibank Holding Company," unpublished thesis, Stonier Graduate School of Banking, June 1978. Devereux argues that "centralized management of funds in a regional bank holding company can free assets for more profitable use; secure the greatest benefit from the assets involved; and obtain funds at the lowest cost; thus, improving overall earnings of the holding company" (p. 108).

13. Section 23A limits a bank's financial transactions (including loans, extensions of credit, and purchases of assets) with any single affiliate to no more than 10 percent of the bank's capital and surplus, and with all affiliates combined to no more than 20 percent. In addition, the statute requires that all bank loans and extensions of credit to affiliates be fully secured. Section 23A was substantially amended in 1982, in part to facilitate greater transactions between banks and affiliated units within a holding company. See also John T. Rose and Samuel H. Talley, "The Banking Affiliates Act of 1982: Amendments to Section 23A," *Federal Reserve Bulletin*, vol. 68 (Federal Reserve Board, November 1982), pp. 693–99.

14. William J. Murray, *Bank Holding Company Centralization Policies*. Prepared for the Association of Bank Holding Companies by Golembe Associates, Inc., February 1979.

15. Gary Whalen, "Operational Policies of Multibank Holding Companies," *Economic Review* (Federal Reserve Bank of Cleveland, Winter 1981–82), pp. 20–31.

16. Also, within the last few years several multistate, multibank holding companies appear to have increased the integration of their bank subsidiaries by adopting common names and logos for all their bank units. Examples include the transition of Western Bancorporation to First Interstate Bancorp; Financial General Bankshares, Inc. to First American Bankshares, Inc.; and Northwest Bancorporation to Norwest Corporation.

Despite the trend toward greater centralization within multibank holding companies, integration of subsidiary banks is still less extensive than that of branch offices of a branch banking system. The evidence on pricing behavior of Florida multioffice banking firms indicates a movement toward more centralized pricing following the consolidation of multibank holding companies into limited branch banking systems in the years since Florida liberalized its branching law in 1976. See David D. Whitehead, III, "Home Office Pricing: The Evidence from Florida," Working Paper Series (Federal Reserve Bank of Atlanta, August 1980).

17. Murray, *op. cit.*, p. 4. A recent study of scale economies in compliance costs for consumer credit regulations at commercial banks reports economies of scale at levels of output up to 375,000 consumer credit accounts, beyond which there are small diseconomies of scale. (Among the sample banks, those that have 350,000 to 400,000 accounts have total assets between $1.9 billion and $8.0 billion.) See Gregory Elliehausen and Robert Kurtz, "Economies of Scale in the Cost of Complying With the Truth in Lending and Equal Credit Opportunity Laws," mimeo (Federal Reserve Board, February 1984).

18. Lucille S. Mayne, "Management Policies of Bank Holding Companies and Bank Performance," *Journal of Bank Research*, vol. 7 (Spring 1976), pp. 37–48. Other studies have reported performance differences across holding company-affiliated banks that are unique to the particular holding company organization. However, these studies have not attempted to relate such differences to individual holding company characteristics such as the degree of holding company centralization. See, for example, Arthur G. Fraas, *The Performance of Individual Bank Holding Companies*, Staff Eco-

nomic Studies, 84 (Federal Reserve Board, 1975), and Peter S. Rose and William L. Scott, "Heterogeneity in Performance Within Bank Holding Company Sector: Evidence and Implications," *Journal of Economics and Business*, 36 (February 1984), pp. 1-14.

19. Robert J. Lawrence, *Operating Policies of Bank Holding Companies: Part I*, Staff Economic Studies, 59 (Federal Reserve Board, 1971).

20. Mayne, *op. cit.*, p. 48.

21. For recent discussions of the different intraorganizatonal effects that may serve to increase the profitability of the consolidated holding company, but which may not be observed at the subsidiary level, see Larry A. Frieder and Vincent P. Apilado, "Bank Holding Company Expansion: A Refocus on its Financial Rationale," *Journal of Financial Research*, vol. 6 (Spring 1983), pp. 67-81, and John T. Rose and Samuel H. Talley, *Financial Transactions Within Bank Holding Companies*, Staff Studies, 123 (Federal Reserve Board, 1983).

22. In a 1978 review of the literature dealing with bank holding company affiliation and cost efficiency, Burke concluded that "banks that affiliate with holding companies incur some expense due to costs of centralization. Small unit banks may not achieve levels of output sufficient to offset these expenses. However, as affiliated banks become larger (over $30 million to $40 million in deposit size), economies of affiliation enable them to achieve lower average costs than independent banks of similar size." Jim Burke, "Bank Holding Company Affiliation and Cost Efficiency," in *The Bank Holding Company Movement to 1978: A Compendium* (Federal Reserve Board, 1978), p. 128.

23. Gary Whalen, "Multibank Holding Company Organizational Structure and Performance," Working Paper 8201 (Federal Reserve Bank of Cleveland, March 1982).

24. Whalen, "Operational Policies of Multibank Holding Companies," *op. cit.* In this same study, Whalen also examined various factors that might account for interholding company differences in centralization. Using regression analysis, he found the degree of centralization to be a function of a number of characteristics of the holding company and its subsidiary banks. By contrast, Lawrence (*op. cit.*) earlier found no relationship between the extent of centralization and various organizational or economic characteristics of the holding company.

25. The valuation ratio is defined as the ratio of the market value of the holding company's stock to its book value.

26. Gary Whalen, "Holding Company Organizational Form and Efficiency," Working Paper 8302 (Federal Reserve Bank of Cleveland, July 1983).

27. Lucille S. Mayne, "Bank Holding Company Characteristics and the Upstreaming of Bank Funds," *Journal of Money, Credit and Banking*, vol. 12 (May 1980), pp. 209-14.

28. *Ibid.*, p. 214.

29. Lucille S. Mayne, "Funds Transfer Between Bank Holding Companies and Their Affiliates," *Journal of Bank Research*, vol. 11 (Spring 1980), pp. 20-27.

30. Rose and Talley, *Financial Transactions Within Bank Holding Companies*, *op. cit.*

31. Amendments to section 23A enacted subsequent to the period covered in the Rose and Talley study substantially expanded the list of collateral that banks can accept when lending to affiliates. To the extent that this facilitates greater lending by holding company banks to their nonbank affiliates within the holding company organization, the flows of funds within bank holding companies in the future may be significantly different from the general patterns observed by Rose and Talley.

32. In a typical annual report to shareholders, the identity of individual bank and nonbank subsidiaries is almost impossible to find. Bank holding companies generally do not provide any financial data on individual subsidiaries.

33. See James H. Wooden and Thaddeus W. Paluszek, "Disclosure Needs of Financial Analysts: Large Bank Holding Companies," *Economic Review* (Federal Reserve Bank of Atlanta, November 1983), p. 77.

34. According to the American Institute of Certified Public Accountants, "There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling interest in other companies." See Accounting Research Bulletin No. 51, "Consolidated Financial Statements" (New York: American Institute of Certified Public Accountants, August 1959).

35. In 1981, the SEC eliminated the requirement for separate, complete financial statements for the parent company and now requires that only condensed financial information about the parent company be presented in the footnotes to a bank holding company's consolidated financial statements.

36. Peat Marwick and Mitchell & Co., *Principles and Presentation: Banking, A Review of 1982 Annual Reports* (July 1983) p. 24.

37. D. P. Jacobs, H. P. Beighley and J. H. Boyd, "The Financial Structure of Bank Holding Companies," Association of Reserve City Bankers, 1975.

38. Jacobs, Beighley, and Boyd, *op. cit.*, pp. 47-48.

39. Beighley, H. P., "The Risk Perceptions of Bank Holding Company Debtholders," *The Journal of Bank Research* (Summer 1977), pp. 85-93.

40. Beighley, *op. cit.*, p. 93.

41. Samuel B. Chase, Jr., "The Bank Holding Company—A Superior Device for Expanding Activities?," in *Policies for a More Competitive Banking System* (Federal Reserve Bank of Boston, 1972), p. 77.

42. Even though the REIT problems have passed, Standard & Poor's considers the strength of the link between the REIT and its sponsor an important rating consideration. They argue that ". . . if the REIT bears the sponsor's name there is a definite economic incentive for the sponsor to keep the REIT solvent and avoid any negative publicity." S&P, *Credit Overview* (August 1983), p. 99.

43. These examples are taken from "Bank and Bank Holding Company Involvement with Real Estate Investment Trusts," David C. Hamilton, mimeo (Federal Reserve Board, May 19, 1978).

44. There were also some other "technical" problems, primarily the accounting method ILA used to value its assets.

45. *Wall Street Journal* (October 8, 1980), p. 3.

46. See press releases from First Chicago Corporation dated April 12, 1985 and July 12, 1985.

47. *Wall Street Journal* (June 18, 1985), p. 8.

48. First Chicago Corporation, Annual Report to Shareholders (1985), pp. 2-3.

49. Tulsa World (October 21, 1984).

50. Tulsa World (October 6, 1984).

51. Tulsa World (October 21, 1984).

52. Walter Wriston, then Chairman of Citicorp, Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, Part II, 97th Congress, U.S. Government Printing Office (October 29, 1981), pp. 589-90.

53. A survey of the earliest Board decisions pursuant to section 3 of the Bank Holding Company Act of 1956 reveals that the Board has always used this approach in its competitive analysis. See, for example, Board orders denying the applications by Northwest Bancorporation, Minneapolis, and Wisconsin Bankshares Corporation, Milwaukee, to organize *de novo* bank subsidiaries. *Federal Reserve Bulletin*, vol. 44 (Federal Reserve Board, January 1958), pp. 11-12, 15-16.

54. See, for example, Board order approving the application by United Missouri Bancshares, Inc., Kansas City, to acquire a bank. *Federal Reserve Bulletin*, vol. 64 (Federal Reserve Board, March 1974), pp. 224-226.

55. See Comptroller of the Currency, *Annual Report*, 1977, 35ff; FDIC, *Annual Report*, 1977, p. 15; and Letter from the Federal Reserve Board's Division of Banking Supervision and Regulation to the Officers in Charge of Examinations, Legal and Research Departments at all Federal Reserve Banks, October 7, 1977 (BHC-127).

56. For example, Federal Reserve reserve requirements are applied to each bank subsidiary individually. In a regime of graduated reserve requirements, this means that the total amount of reserves required of a multibank holding company is less than if all the sister bank subsidiaries were aggregated to a single banking entity.

57. In December 1969, the Congress specifically authorized the Federal Reserve Board to apply both reserve requirements and interest rate controls to funds received by member banks from the

issuance of commercial paper by the bank's holding company (*U.S. Code Congressional and Administrative News*, 91st. Cong., 1st Sess. (1969), vol. 1, pp. 392–400, 1472–1473, 1521). See also *Federal Reserve Bulletin*, vol. 56 (Federal Reserve Board, January 1970), pp. 35–37, 105–106.

58. Board of Governors of the Federal Reserve System, *Annual Report*, vol. 57 (1970), pp. 75–76. See also *Federal Reserve Bulletin*, vol. 56 (Federal Reserve Board, August 1970), p. 657.

59. David B. Humphrey and Donald T. Savage, "Bank Use of Downstreamed Commercial Paper and the Impact of Reserve Requirements in Controlling Liability Usage," *Journal of Economics and Business*, vol. 33 (Winter 1981), pp. 109–114.

60. *Ibid.*

61. *U.S. Code Congressional Administrative News*, 93rd Cong., 2nd Sess. (1966), Part I, pp. 1793–1794, and Part II, pp. 6249–6252, 6264-6265.

62. Variably denominated payments instruments include money orders and similar payments instruments, such as cashier's checks and certified checks.

63. See Board Order approving the application by Citicorp., New York, to engage in the activity of issuing and offering on a consignment basis general purpose, variably denominated payments instruments. *Federal Reserve Bulletin*, vol. 63 (Federal Reserve Board, April 1977), pp. 416–419.

64. See Board Order approving the application by BankAmerica Corporation, San Francisco, to engage *de novo* in the issuance and sale of payments instruments and related activities. *Federal Reserve Bulletin*, vol. 70 (Federal Reserve Board, April 1984), p. 364.

65. The discussion in this section focuses on *domestic* bank holding companies. Regulation of foreign bank holding companies is much narrower in scope and generally concentrates on the domestic subsidiaries of those holding companies.

66. Initially, section 23A applied only to banks that were members of the Federal Reserve System. However, in 1966, the Congress amended the Federal Deposit Insurance Act to extend coverage to insured nonmember banks.

67. Digest of Hearings Before a Subcommittee of the Senate Committee on Banking and Currency pursuant to S. Res, 71st Cong., 3d Sess. (1931); Operation of the National and Federal Reserve Banking Systems, p. 1066.

68. See *Bank Holding Company Act of 1955*, Report No. 609, House Committee on Banking and Currency, 84th Cong., 1st Sess. (May 20, 1955), pp. 17–18; and *Control of Bank Holding Companies*, Report No. 1095, Senate Committee on Banking and Currency, 84th Cong., 1st Sess. (July 25, 1955), p. 15.

69. "Report under Bank Holding Company Act," *op. cit.*, p. 793.

70. Section 5(c) of the Bank Holding Company Act authorizes the Federal Reserve Board to acquire reports from bank holding companies as well as to examine each holding company and each subsidiary thereof. Financial statements for each bank subsidiary are filed with the bank's primary federal supervisor.

71. Board Order approving the application of NCNB Corporation, Charlotte, N.C., to acquire a mortgage banking company. *Federal Reserve Bulletin*, vol. 48 (Federal Reserve Board, September 1972), p. 844. To demonstrate its commitment to the principle that holding companies should be a source of strength to their subsidiary banks, the Board has denied applications that it felt were inconsistent with this objective, pursuant to section 3(c) of the Bank Holding Company Act, as amended. See, for example, Board Orders denying the applications by Sellon, Inc. , Toledo, Ohio, to acquire a bank holding company, *Federal Reserve Bulletin*, vol. 48 (Federal Reserve Board, August 1972), pp. 729–730 and First Lincolnwood Corp., Lincolnwood, Illinois, to form a bank holding company, *Federal Reserve Bulletin*, vol. 62 (Federal Reserve Board, February 1976), pp. 153–154. The First Lincolnwood Corp. decision was challenged in court but was eventually upheld by the U.S. Supreme Court. (*Board of Governors of the Federal Reserve System* v. *First Lincolnwood Corp.*, Supreme Court of the United States, No. 77–832, December 11, 1978.)

72. See Board of Governors of the Federal Reserve System, *Annual Report*, vol. 59 (1972), p. 200. The same recommendation also appeared in the Board's *Annual Report* for 1973 (p. 237). The Board made no further recommendations regarding section 23A until it proposed a complete redrafting of the statute in 1977, as discussed later in this section.

73. For a discussion of the heightened interest of the Federal Reserve in holding company supervisory policy during this period, see Carter H. Golembe, "The Supervision and Regulation of Bank Holding Companies: An Assessment of Objectives and Implementation," prepared for the Association of Bank Holding Companies by Golembe Associates, Inc., November 13, 1978, pp. 53–56. See also Lucille S. Mayne, "New Directions in Bank Holding Company Supervision," *Banking Law Journal*, vol. 95 (September 1978), pp. 729–742.

74. Probably the best known case involved Hamilton National Bank of Chattanooga, which failed after having purchased a large amount of low-quality mortgages from a mortgage banking subsidiary of the bank's parent holding company. Recall the discussion of these problems in the previous section of this study.

75. See Board of Governors of the Federal Reserve System, *Annual Report*, vol. 64 (1977), pp. 372–373.

76. Recent amendments to section 23A are discussed in John T. Rose and Samuel H. Talley, "The Banking Affiliates Act of 1982: Amendments to Section 23A," *Federal Reserve Bulletin*, vol. 68 (Federal Reserve Board, November 1982), pp. 693–699.

77. See Phil Battey, "CofC Tells Banks Not to Enrich Insiders with Exorbitant Fees," *American Banker* (September 11, 1978), p. 1.

78. Board of Governors of the Federal Reserve System, "Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks That are Members of the Federal Reserve System," Press Release (September 25, 1978).

79. Among the possible diversion of income practices listed by the Board are "(1) management or service fees, or other payments assessed by the parent company or any affiliated entity and paid by the bank, that bear no reasonable relationship to the fair market value, cost, volume, or quality of services rendered by the affiliate to the subsidiary bank; (2) balances maintained by the subsidiary bank primarily in support of parent borrowings without appropriate compensation to the bank; (3) prepayment of fees to the parent or other nonbank affiliates for services that have not yet been rendered; and (4) non reimbursed expenses incurred by the bank that primarily support a nonbank activity." See letter from the Board's Division of Banking Supervision and Regulation to the Officer in Charge of Examinations at each Federal Reserve Bank, March 19, 1979 (SR–533).

80. *Ibid.*

81. See Board of Governors of the Federal Reserve System, *Annual Report*, vol. 66 (1979), p. 276.

82. Two reports issued by the General Accounting Office in 1980 and 1981 emphasized the integrated nature of the bank holding company organization and suggested that bank supervisors treat holding company systems as single entities. The GAO offered a number of recommendations, including better coordination of supervisory efforts among the three federal bank regulatory agencies. See Comptroller General of the United States, *Federal Supervision of Bank Holding Companies Needs Better, More Formalized Coordination*, GGD–80-20, February 12, 1980; and *Federal Reserve Could Improve The Efficiency of Bank Holding Company Inspection*, GGD–81-79 (August 18, 1981).

83. Federal Reserve Board, *Annual Report* (1979), p. 277. See also *Federal Reserve Bulletin*, vol. 66 (Federal Reserve Board, January 1980), p. 35.

84. See letter from the Board's Division of Banking Supervision and Regulation to the Officer in Charge of Examinations at each Federal Reserve Bank, February 1, 1982 (SR 82–6 (FIS)).

85. See *Federal Reserve Bulletin*, vol. 68 (Federal Reserve Board, January 1982), pp. 33–34. See also *Federal Reserve Bulletin*, vol. 69 (Federal Reserve Board, July 1983 and December 1983), pp. 539–540 and 898.

86. Samuel H. Talley, *Bank Capital Trends and Financing*, Staff Studies 122 (Federal Reserve Board, 1983), p. 16. An exception to the consolidation rule is that in the case of relatively small holding companies (consolidated assets under $150 million) the guidelines apply to the bank only, provided that the company does not engage in any nonbank activity involving significant leverage and that no significant debt of the parent holding company is held by the general public.

Chairman Greenspan's Response to Written Questions
From Senator Chafee in Connection with the Hearing
Held on December 1, 1987

1. Assume that a bank's securities activities are split among the bank, a securities subsidiary of the bank and a securities affiliate. Assume the SEC would have functional regulation of the securities subsidiary and the securities affiliate. Specifically which securities activities should be in each of the three? (You may decide that you do not wish to use all three.)

Answer: We believe that certain securities activities that are now conducted in banks could reasonably and with prudence continue to be conducted in banks. These would include discount brokerage activities, underwriting of the general obligation and revenue bonds of states and municipalities, and sales of mutual funds. These activities involve no risk to the bank (brokerage activities) or involve the underwriting of instruments that have special risk characteristics.

All other underwriting activities should be conducted in an affiliate of a holding company. We believe that, as a general matter, such activities need to be separated from the bank in order to assure that the federal safety net does not extend to them.

We do not draw a distinction between the bank and a subsidiary of the bank because the close identification between the two mitigates against effective separation. This relationship has a much greater chance for passing on the risks of the securities activities conducted in the subsidiary to the parent bank and, consequently, to the federal safety net. That is to say, there is considerably less chance to achieve the corporate separateness necessary to protect the bank because of the fact that the gains and losses of the subsidiary are consolidated into the bank and because there is a direct line of ownership control from the bank to the securities subsidiary.

Therefore, the important and appropriate distinction from our perspective is between a holding company subsidiary and a bank and its subsidiary. Except for the limited scope of securities activities that may be conducted in a bank that I have outlined above, we believe that the necessary separation to assure insulation of the bank from securities activities is best achieved through the holding company framework.

2. Do you feel that present civil dollar and criminal dollar and incarceration penalties with regard to illegal banking activities are sufficient? If not, what improvements in the law should be made?

Answer: The present civil penalty for violation of the Bank Holding Company Act is $1,000 per day for each violation. Criminal penalties involve a fine of up to $10,000 and/or imprisonment for up to one year. While we believe that the criminal penalties are adequate, an increase in the amount of civil money penalties up to $10,000 per day may be warranted. Nevertheless, we would like to stress that the major emphasis should be placed on establishing workable firewalls that are consistent with business practices rather than creating an untenable set of relationships that can only be applied through legal coercion. We do not believe that that would be a viable arrangement.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
ROBERT L. CLARKE

Q.1 (A) It seems to me that Chairman Seidman raises the pivotal question: Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound even from their owners, affiliates and subsidiaries?

A. 1 I am confident that it will be possible to insulate commercial banks from their owners, affiliates, and subsidiaries. In my testimony I described a framework for reform that, like a number of other general blueprints for reform, is founded on the principle of corporate separateness. Under my proposal, banks would be permitted to invest in insulated subsidiaries only funds that are in excess of their regulatory capital requirement. Moreover, by deducting those investments from the bank's capital account when assessing its compliance with that requirement, we could ensure that any losses the subsidiary may experience will not reduce the bank's capital below its regulatory requirement. My proposal also embraces the many existing safeguards that apply to transactions between banks and their affiliates. Those safeguards perform two functions: they provide additional limits to a bank's exposure to financial difficulties that affiliates may experience, and they guard against abuse by insiders. Examples of such existing safeguards were appended to my written statement, and I suggested additional safeguards in my testimony.

S. 1974, which Senator Proxmire introduced on behalf of himself and Senator Garn, provides enhanced safeguards through stronger enforcement authority. The measures contained in that bill were suggested and uniformly supported by the federal supervisors of insured depository institutions. They include an increase in the number of parties against whom a cease-and-desist order may be issued, clarification of the ability of the banking agencies to require reimbursement from directors, and a provision ensuring that a person removed by one agency will not be employed by a bank supervised by another agency. The law should also provide that the primary bank regulatory agency has adequate enforcement authority to address effectively breaches of any safeguards imposed on the relationship between the bank and its subsidiary or affiliate, including those by their officers and directors.

If experience should prove any of the proposed or existing safeguards to be less than adequate, the OCC is prepared to make additional recommendations. Some are discussed in my answer to one of the questions submitted by Senator Chafee and include an increase in civil money penalties and authority to order divestiture.

Q.1 (B) If a regulatory framework can be devised to establish an effective firewall that insulates banks from their securities affiliates, then shouldn't such a firewall also enable banks to be insulated from their commercial affiliates?

A. 1 The wall that would separate commercial banks from securities affiliates would provide a sound foundation for creating a wall between a bank and commercial affiliates. Most of that wall is in place today.

With few exceptions, there is little need for additional safeguards beyond those already in place. Existing safeguards are abundant, as demonstrated in an appendix to my written statement.

Some additional measures are, however, necessary. As I urged in my written statement, "... bank supervisors could do much to ensure that bank capital is insulated fully from the potential risks of affiliation by deducting a bank's investment in insulated affiliates from the bank's capital when assessing the adequacy of bank capital." I also suggested that "... in order to strengthen the corporate veil, we should consider the benefits of amending the national banking laws to prohibit national banks from being held liable for the obligations of their insulated affiliates, unless specifically assumed by a prior contractual arrangement or in egregious cases such as gross negligence or willful misconduct."

Q. 1(C) S. 1905, The Depository Institution Affiliation Act creates such a firewall; however, do you think this wall can be strengthened? If so, how?

A. 1 S. 1905 would rely on a combination of safeguards that include: authorization for the appropriate Federal regulatory agency (AFRA) to require "... each insured bank or insured institution subject to its jurisdiction that is controlled by a depository institution holding company to maintain additional capital...."; the provisions of sections 23A and 23B of the Federal Reserve Act; substantial rulemaking authority for each AFRA; and prohibitions against certain commercial bank loans to a securities affiliate and to firms issuing securities underwritten by that affiliate. Together with the considerable safeguards found in the securities laws, there would appear to be significant protections.

There is no question that the wall that would be created by the provisions of S. 1905 could be strengthened; whether such a wall should be strengthened is a question that deserves more study. As I pointed out in my testimony, my preferred approach is to ensure that a bank's capital is insulated from the financial risks of its affiliates by deducting its investment in a "new-powers" affiliate from the bank's capital account for purposes of determining bank capital adequacy.

When imposing additional safeguards, care should be taken that they are not so onerous that they remove the incentive for banks to undertake new activities.

For example, I have some reservations about the provisions in S. 1905 that would prohibit all but fully secured, intra-day loans to securities affiliates. Even without that restriction, loans to securities affiliates would be subject to the provisions of sections 23A and 23B of the Federal Reserve Act, which generally require that such loans be consistent with safe and sound banking practices, be limited in amount and supported by specified types of collateral, and be conducted on an "arms-length" basis. Moreover, like all loans in a bank's portfolio, they would be subject to examination by the bank's supervisor. Unless a persuasive case can be made on the grounds of commercial bank safety and soundness, there is no reason for treating loans to securities affiliates differently than loans to other bank affiliates.

I have similar concerns regarding some of the restrictions on lending to customers of affiliates contained in S. 1905, in particular the prohibition against making loans to "enhance the marketability of the company's securities" or to permit it to repay "principal and interest on securities underwritten by the bank's securities affiliate". In my view, a better approach is to permit banks to make such loans, and once made, to subject those loans to the usual scrutiny performed by bank examiners.

Q.2 Do you agree with Chairman Seidman's testimony that "by eliminating only the Glass-Steagall restrictions, a fair competitive two-way street between securities firms (and other financial service providers) is not assured since many securities firms are affiliated with companies engaged in activities not permitted to bank affiliates. Total competitive equality between banks and securities firms can be established only if the activity restrictions and other portions of the Bank Holding Company Act also are removed from qualified securities firms."?

A.2 This question raises issues identical to those posed by Senator Garn in one of his questions. As I noted in my reply to that question, it may be counterproductive to require securities firms to divest some activities in order to enter banking. It is my hope that financial-reform legislation will eventually encompass amendments to the banking laws that permit depository institutions to affiliate with the broadest possible array of businesses. Such amendments would include changes in the bank holding company laws that would expand permissible affiliations by commercial banks.

Q.3 Both S. 1891 and S. 1905 would establish a new regulatory mechanism with responsibilities over the financial services sector that consists of the heads of many existing financial services sector agencies and other government entities. Do you prefer the Financial Services Committee concept in the D'Amato/Cranston bill or the Commission called for in the Wirth/Graham bill?

A. 3 As a matter of principle, I favor the approach taken in the D'Amato/Cranston bill over that of the Wirth/Graham bill. That preference is based primarily on the more extensive financial reform that would be possible under the D'Amato/Cranston proposal.

To some degree, the differences between the two "oversight" bodies reflect the extent of financial reform promoted by the proposed laws. The Wirth/Graham bill would permit commercial banks to affiliate only with financial-services firms. Consequently, its "Commission" is empowered to determine which services are "financial" and to promulgate regulations enforcing those determinations. Under the D'Amato/Cranston plan, commercial banks may affiliate with any kind of business. There is no need to distinguish between financial and non-financial activities.

Differences between the two bodies also reflect alternative approaches to bank supervision. I favor the role accorded to the D'Amato/Cranston Committee, which is more advisory. For example, under the Wirth/Graham bill, the Commission would set capital requirements for financial holding companies and their affiliates. The D'Amato/Cranston Committee has no such responsibility; each "appropriate Federal regulatory agency" would set capital requirements for its respective institutions. The D'Amato/Cranston Committee would provide a forum for needed coordination of supervisory policy among federal regulators of financial organizations, without creating another extensive bureaucracy to govern those firms.

Q.4 In response to written questions submitted pursuant to your testimony of January 21, 1987, regarding the separation of banking and commerce, you stated in relevant part:

> "Second, I do not necessarily agree that commerce and banking need to remain separate. I believe that appropriate safeguards can be put in place to protect the bank against risks associated with a nonfinancial firm.... Our ultimate objective should be to strengthen our financial system by removing obsolete rules that restrict the ability of banks and other providers of financial services to remain competitive in the global marketplace. Our pursuit of that objective should not be hampered by efforts to maintain an arbitrary distinction between banking and commerce."

A. However, in your testimony of December 3, 1987, you abandon the goal of breaking down the arbitrary distinction between banking and commerce. Is this a change in your substantive position or have you adopted your present position due to your political judgment that amendments to the Bank Holding Company Act are impractical at this time?

B. Would you oppose legislative efforts to break down the barrier between banking and commerce assuming appropriate safeguards are provided to insulate the depository institution from its commercial affiliates?

C. Specifically, what appropriate safeguards (beyond those already existing) were you contemplating when you referred to the "appropriate safeguards" that could be put into place to protect the bank against risks associated with a nonfinancial firm?

A.4 My testimony of December 3, 1987, does not represent a change in my substantive position. As I stated to this Committee in January 1987, and as I have reaffirmed in my answers to many follow-up questions posed by various Committee members, our ultimate objective should be to promote competition in all financial and nonfinancial markets. I favor the most effective means available to achieve that objective.

As I noted in my answer to a previous question, with few exceptions, there is little need for additional safeguards beyond those already in place.

In my written statement, I discussed those additional measures. I favor deducting a bank's investment in insulated affiliates from the bank's capital when the bank supervisor assesses the adequacy of bank capital. I also think that, in order to strengthen the corporate veil, we should consider the benefits of amending the national banking laws to prohibit national banks from being held liable for the obligations of their insulated affiliates, unless specifically assumed by a prior contractual arrangement or in egregious cases such as gross negligence or willful misconduct.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CHAFEE FROM ROBERT L. CLARKE

Q.1 Assume that a bank's securities activities are split among the bank, a securities subsidiary of the bank and a securities affiliates. Assume the SEC would have functional regulation of the securities subsidiary and the securities affiliate. Specifically which securities activities should be in each of the three? (You may decide that you do not wish to use all three.)

A.1 In response to a request from Senator Proxmire, the OCC is working with the FDIC and the SEC to develop a unified position on the issues raised by this question. Full agreement had not been reached by the required date of submission of the answers to the follow-up questions.

Q.2 Do you feel that present civil dollar and criminal dollar and incarceration penalties with regard to illegal banking activities are sufficient? If not, what improvements in the law should be made?

A.2 As I indicated in my testimony, these areas merit additional consideration. More specifically, on December 19, 1987, Senator Proxmire on behalf of himself and Senator Garn introduced S. 1974, a bill that would strengthen the hand of the supervisory agencies in dealing with those who abuse financial institutions. It was developed through the joint efforts of the federal bank and thrift supervisors. Other enhancements, such as the suggestion in S. 1891 that civil money penalties be increased to as much as $10,000 per day (a sizeable increase over the current general limit of $1000 per day) are also worthy of consideration.

Additionally, OCC staff are studying the merits of legislative changes that would grant the Comptroller express authority to:

- order a bank to divest a subsidiary in certain specified circumstances;
- issue a temporary cease-and desist order for a breach of the safeguards insulating a bank from its "new-powers" subsidiaries or other affiliates; and
- order removal of a bank official who violates those safeguards.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ROBERT L. CLARKE

Q.1 Bank profitability trends have become one of your central arguments in the debate on new bank powers. So that I can get a better idea of how this position relates to the industry in my state, would you please provide data concerning the profitability of Michigan banks over at least the past five years, both for all banks together and segmented by bank size?

A. 1 The tables on the following page document profitability trends among commercial banks in the State of Michigan for the years 1980 through 1986, and the first half of 1987.

In general, bank performance is highly dependent on the health of the economy served. Thus, the profitability of Michigan's banks deteriorated over the period between 1980 and 1982 when its economy and the U.S. economy were in a recession. As Michigan's economy recovered in the mid-1980's, bank profitability recovered. Employment in Michigan grew 14 percent between 1982 and 1986. That growth is attributable, in part, to the recovery of the automobile industry, which is directly responsible for 20 percent of the state's employment, and strong growth (17 percent) in Michigan's private services sector between 1982 and 1986.

Bank dependence on the local economy, however, is a double-edged sword. When the local economy does well banks tend to do well; the converse is also true. With expanded opportunities to diversify their sources of earnings, banks could become less dependent on local economic conditions. That would promote a safer, sounder, and more stable banking system.

Commercial Banks in Michigan 1/

Median Return on Assets 2/
1980-1987
(Percent)

Asset size ($ Millions)	1980	1981	1982	1983	1984	1985	1986	1987 3/
Under 50	.90	.80	.74	.81	.81	.88	.87	.91
50-100	.81	.67	.74	.79	.86	1.03	.96	1.02
100-300	.81	.64	.63	.75	.87	.92	.94	.98
300-1,000	.79	.61	.78	.91	.97	1.00	1.01	1.16
over 1,000	.66	.49	.50	.68	.77	.84	.83	.79

Banks with Losses,
1980-1987
(Percent)

Asset size ($ Millions)	1980	1981	1982	1983	1984	1985	1986	1987 3/
Under 50	8.1	9.1	14.0	13.4	13.2	11.3	12.5	8.7
50-100	2.7	7.8	4.8	10.3	10.4	8.1	11.5	4.2
100-300	1.8	4.6	13.6	4.4	4.2	6.4	7.5	2.6
300-1,000	0.0	7.1	10.0	8.3	0.0	3.9	0.0	0.0
over 1,000	11.1	14.3	28.6	12.5	14.3	0.0	0.0	0.0

Number of Commercial Banks,
1980-1987

Asset size ($ Millions)	1980	1981	1982	1983	1984	1985	1986	1987 3/
Under 50	210	198	186	179	159	142	120	115
50-100	74	77	84	87	96	99	104	96
100-300	56	65	66	69	72	78	80	76
300-1,000	11	14	20	24	28	26	30	25
over 1,000	9	7	7	8	7	10	10	9
total	360	361	363	367	362	355	344	321

1/ Excludes banks in operation less than three years.

2/ Return assets is net income, after adjustment for federal income tax, as a percent of average assets.

3/ June 1987.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM ROBERT L. CLARKE

Q.1 The Proxmire-Garn Bill creates a special exemption from some, but not all, bank holding company regulation for certain "pure" securities firms that buy banks. The exemption applies if 80 percent of the assets and revenues of the combined organization, including the bank, is related to securities activities. This is designed to make it more attractive for securities firms to buy banks, to make it more of a "two-way street," but the problem is that many securities firms are engaged in other financial activities that are prohibited by the Bank Holding Company Act. These firms would have to give up these other activities in order to acquire a bank. Would you favor an additional exemption from the activities restriction of the Bank Holding Company Act for firms primarily engaged in securities activities or financial activities? If so, what suggestions would you make?

A.1 Our ultimate objective should be to promote increased competition in all segments of the financial-services marketplace. Requiring securities firms to divest some activities in order to enter banking could well decrease competition in the markets served by the divested activities. That would not be in the best interest of consumers. Consequently, it is my hope that financial-reform legislation will eventually amend the banking laws and permit commercial banks to affiliate with the broadest possible array of businesses. If Congress were to adopt the incremental approach to such expansion found in the Proxmire-Garn Bill, commercial banks should be granted unambiguous authority to affiliate with all manner of securities firms as well as insurance, real estate, and real estate related (*e.g.*, title search, property appraisal and management, and property development) businesses.

Q.2 It seems to me that any restructuring plan enacted into law should require increased supervisory resources for the regulators, especially in the initial years of operation. Do you agree?

A. 2 Yes, even if the restructuring plan incorporates functional regulation by functionally separate regulators. As the number of businesses with which banks may affiliate expands, supervisors of commercial banks will need adequate resources to evaluate and enforce bank compliance with the laws that would constitute the "wall" insulating the commercial bank from its subsidiaries and affiliates.

Resource needs are not measured simply in numbers of personnel. As banks engage in other business activities and the traditional business of banking becomes more complex, staff expertise is a major concern. The experience levels of OCC staff have been falling and staff turnover is unacceptably high. The causes of this turnover are principally: competition from the private sector (a traditional problem) and, more recently, competition from other federal regulators of financial institutions, especially the Federal Home Loan Bank System, who can provide substantially higher compensation to senior staff. Attention must be directed to providing competitive compensation, which will enable us to attract and keep qualified staff, to the supervisors of all federally insured financial institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
JOHN G. HEIMANN

1. In endorsing Mr. Corrigan's proposal for a Financial Services Oversight Commission, you state that: "We must build into the system effective oversight of the totality, not just the parts."

   Likewise, when you testified before the Committee on October 13, you suggested that supervising the various pieces of a holding company is not enough, and that Congress must provide for supervision of the whole.

   I agree. But, doesn't that principle run counter to S.1905, which seems to be based on the notion that no part of a holding company should have more than one Federal regulator, and that no regulator should be allowed to deal with the big picture? Please explain your answer.

Heimann: Speaking as a former regulator, I do believe that Congress should extend the responsibilities of the commission in S.1905 to include oversight over the financial services holding company that owns a federally-insured depository institution. As I noted in my prepared testimony, oversight of the totality combined with functional regulation should contribute to the security of our nation's financial services system.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
JOHN G. HEIMANN

Q.1. Mr. Corrigan's testimony shows his strong views that regulation is critical for the consolidated holding company that owns financial institutions, especially banks. Could this be accomplished by the joint commission of federal regulators as either the Wirth-Graham or Cranston-D'Amato bills suggests? Do you believe it necessary to have direct regulation of a bank holding company?

Heimann: As I have said, my regulatory experience leads me to believe that oversight of the holding company is necessary. Both the Wirth-Graham and Cranston-D'Amato bills would form commissions that could have their responsibities expanded to undertake this oversight role.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM EDWARD O'BRIEN

Q. You allege that FDIC insurance provides an unfair competitive advantage for banks. Isn't it true that cash deposits or the equivalent held by your members are federally insured by SIPC?

A. To properly answer this question, one must distinguish between how insured deposits are used within a bank and what a broker/dealer may do with cash that may temporarily be in a brokerage account awaiting investment in securities.

A bank's principal source of funds are deposits. These deposits make up the capital base of a bank and are used to fund profit-making activities such as commercial loans. The FDIC guarantees a depositor that 100¢ of each dollar deposited up to $100,000 will be returned to him regardless of what might happen to the bank or in what banking activities his insured deposits are used. This federal guarantee permits banking organizations to solicit deposits at less than a market rate thereby raising capital for business purposes at a cost lower than a broker/dealer who must either borrow from banks, or borrow from others in the securities market place without a guarantee. It is this advantage, the lower cost of raising capital, that creates a basic unfairness between banks and broker/dealers.

This unfairness is not corrected by the Securities Investor Protection Corporation. This corporation is designed to protect investors accounts. The securities or cash in investors accounts cannot be used by the broker/dealer for its own capital or business needs. They are prohibited by law from doing that. The Securities Investor Protection Corporation only comes into effect in a broker/dealer liquidation, and only provides protection to an investor if the securities or cash that were in his brokerage account are not at the broker/dealer. They then replace, or give the investor the current market value of the securities in his account not their original cost. SIPC does not protect the investor against market risk. It is true that cash awaiting investment is covered under those circumstances up to the amount of $100,000, but it is equally true that at no time has the broker/dealer had the ability to use the cash balance, or the securities in the investor account for his own business purposes. A broker/dealers capital is not raised with a government guarantee, a bank is.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
EDWARD I. O'BRIEN

1. A December article in the Financial Times reported that the pace of liberalization in Japan's financial community appears to be picking up speed. Among other things it mentioned that a recently leaked draft report of the Ministry of Finance's Financial System Research Council recommended the abolition of Article 65 which separates commercial banking and investment-banking in Japan. The article reported that the Japanese securities industry is resisting such action because it "does not want to see any system established that would enable the banks to encroach on its lucrative territory."

   Last week Under Secretary Gould affirmed to us that the Japanese are studying repeal of their own Glass-Steagall Act and said if the Japanese acted before we did "it would hurt the competitive position of the American banks."

   Do we agree with the under Secretary in that regard? If not, why not?

Response:

Before answering this question, SIA believes that the report in the Financial Times of December 3, 1987, needs to be put in context. We have been informed by the Japanese Center for International Finance that the study in question would be the equivalent here in the United States of a study released by a small group of economists that would work for the General Accounting Office. While there's substantial interest in Japan with regards to potential modification of the Glass-Steagall Act here in the United States, we were assured that the Japanese Minister of Finance is not actively examining or studying modifications of Articles 65.

SIA believes that every sovereign nation should be able to dictate the terms and conditions under which financial institutions operate in their country. Given our inability to determine what effect the lessening of restrictions in Japan would have on the competitive posture of American banks in that country, we are unable to evaluate Secretary Gould's assertion.

2. A large Swiss Bank, Credit Suisse, has a substantial ownership interest in First Boston. A large Japanese Bank, Sumitomo, has a sizable interest in Goldman-Sachs. We hear stories every day that our largest securities firms will soon be owned by foreign banks.

   If there is an irreparable conflict between commercial and investment banking, why shouldn't the Congress order these foreign banks to divest themselves of their investments in U.S. securities firms?

Response:

Certainly SIA believes that the Congress in 1933 recognized the serious conflict between commercial and investment banking, and decided not to regulate that conflict, but to ban the combination of the two activities. It also appears to us that the Congress in 1978 made decisions with regard to foreign ownership of U.S. financial institutions when it passed the International Banking Act of 1978. Certainly if the Congress wants to change that legislation, SIA would be more than willing to examine any proposed legislation, and to solicit from its members a position with regards to that legislation.

3. Under S.1886 a bank may choose to enter the securities business through an affiliate. It may not enter into other financial businesses or enter into commercial activities. On the other hand the securities industry has a choice. It may either combine securities with banking or securities with other businesses. The rules are clear for anyone to follow. There is no ex-post asymmetry in the treatment of bank-securities combinations depending upon whether they were originally a bank or a securities firm at first.

   Why is this not a two-way street?

Response:

SIA has some difficulty understanding the thrust of this particular question since the asymmetrical treatment (the lack of a two-way street) is in fact caused by whether you are a bank or a broker/dealer prior to the enactment of this legislation. Currently broker/dealers are not restricted from engaging in a wide variety of real estate, insurance, financial activities, and corporate ownership that are prohibited to banks and bank holding companies. A broker/dealer therefore in order to achieve banking powers would have to divest substantial activities in which they currently engage. Banks would not have to divest any activities. This effectively precludes most SIA members from taking advantage of any additional banking powers. For a more detailed analysis of the impact on our top 25 members, we refer you to the answers provided to Senator Garn's question, and to our testimony presented to the House Banking Committee on February 2, 1988 (copy attached) at pages 12 and 13.

4. One argument we often hear against the repeal of Glass-Steagall is that it would be unfair to allow the banks to compete against securities firms when banks have all of the advantages provided by deposit insurance and access to the discount window. It is often alleged that the regulators will not allow a large bank to fail, and that this federal safety net gives large banks a built-in competitive edge.

   In the wake of Black Monday, isn't it clear that many securities firms also enjoy the protections given by the federal safety net. Quick and decisive action taken by the Federal Reserve and the banks helped to prevent any securities firms from going under because of a temporary liquidity squeeze.

   If this analysis is correct, doesn't it imply that the federal safety net argument is no longer a valid reason for not repealing Glass-Steagall?

Response:

Before directly answering your question, some background must be given with regards to the advantage deposit insurance and access to the discount window gives banks. These two statutorily provided benefits are designed to permit banks to accumulate deposits at less than market rates. This permits banks to accumulate assets that it uses in its business at costs lower than competing broker/dealers. Since a broker/dealer would have to borrow from banks, or raise money in the capital markets without the benefit of the guarantee, this is truly a competitive advantage.

On October 19 and 20, the was a precipitous drop in the stock market, and because of securities regulations, broker/dealers were required to mark to market their inventory creating substantial real and immediate losses. At the same time, the Federal Reserve substantially increased liquidity in the banking industry and that liquidity was lent in the ordinary course of banks lending business to broker/dealers. Please refer to the testimony of Alan Greenspan given to the Senate Banking Committee of February 2, 1988, at pages 5, 6, and 7, for greater detail. Apparently some banks were reluctant to lend additional funds to some broker/dealers, but action by the Federal Reserve Bank of New York reversed that reluctance. This situation was widely reported in the Wall Street Journal article of November 20, 1987. SIA testimony to the House Banking Committee dated February 2, 1988, at pages 6, 7, and 8 provides additional background on this issue.

SIA believes that the system worked perfectly on October 19 and 20. The market risk of securities trading and investment was limited to the broker/dealer system, while the banking system provided the necessary liquidity to stabilize markets through loans to broker/dealers. At no time was the federal safety net that underlies deposits ever directly extended to the broker/dealer community, since liquidity was provided to broker/dealers in the ordinary course of banks' lending business. Frankly we believe that the way the two industries operated on October 19 and 20 is an ample demonstration of the wisdom of the Glass-Steagall Act separation. It eliminated any potential risk to the federal safety net, while isolating market risk in broker/dealers.

SECURITIES INDUSTRY ASSOCIATION

WASHINGTON OFFICE: 1850 M Street, N.W., Washington, D.C. 20036 (202) 296-9410

MEMORANDUM

FROM: Robert A. Gerard, Chairman, Municipal Finance Committee, Securities Industry Association

TO: William Proxmire, Chairman, Senate Committee on Banking, Housing, and Urban Affairs

SUBJECT: Eliminating Unfair Bank Advantage in Non-Banking Activities, Preserving the Possibility of Independent Securities Firms and Limiting the Expansion of the Direct Coverage of the Federal Safety Net While Exploring Ways for the Fair Dismantling of the Wall Between Banking and Commerce

DATE: February 4, 1988

The Securities Industry Association testified before the Senate Banking Committee on December 8, 1987 and was asked by the Chairman to attempt to put its thoughts about appropriate legislation into specific form. The Association has had numerous discussions internally and with others concerned with the problem of government-supported banking institutions, which occasionally include bank holding companies, competing in non-banking businesses against businesses which do not enjoy government backing. SIA recognizes the desire of banks, of diversified financial firms and of other units of commerce to affiliate with one another. SIA also strongly believes it important for the United States that the independent securities firm, the independent insurance firm and other independent firms have a chance to be born, survive, compete and succeed. The entrepreneurial spirit is an essential ingredient of the American economy.

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SIA has also been concerned, along with other citizens, about the implications of spreading the federal safety net that directly supports banking to an increasing number of sectors of the economy. Not only does such an extension have the potential for adding to the intrinsic unfairness of bank competition in non-banking areas, it unnecessarily increases risks ultimately borne by the American taxpayer. Assuming nonetheless that Congress wishes to give serious consideration to allowing further bank entry into non-banking businesses, it is SIA's view that a way to permit the affiliation of all units of commerce with banking should be seriously examined. Anything less would unfairly benefit government-supported banking institutions at the expense of competitors precluded from affiliating with banks.

It is recognized that eliminating all restrictions on affiliations by and with banks is a matter of great magnitude and complexity. No one knows whether there is an effective substitute for Glass-Steagall and the other components of the wall between banking and commerce. Will firewalls work? No one knows. Therefore, when we appeared before before your Committee, we suggested the outline of a safe, sane and fair approach in our written Statement submitted for the record (Part VI). Our draft legislation evolved from that outline. We summarize here what the enclosed draft legislation attempts to do. (A section-by-section analysis is also enclosed.)

It is proposed that the process go forward carefully in stages, focusing principally on the securities industry as the test area for the new restructuring:

1. The first stage would be to restructure the present operations of member banks and bank holding companies to separate out securities and perhaps other non-banking businesses into completely segregated, separately-capitalized corporations isolated from bank and thrift advantages. As effective a firewall as possible would be constructed to wall off direct and indirect bank and thrift credit advantages (extensions of credit, unfair combining of credit with other services and the like). A statement of policy should be included that the federal safety net does not extend beyond federally-insured banks and thrifts. Important oversight responsibilities would be given to the Securities and Exchange Commission to ensure compliance with the various self-operative prohibitions and other elements of the firewall. Congress should retain complete control of the

process of change, particularly in the areas of securities, insurance and real estate, and eliminate the power of regulators and state legislatures to expand non-banking powers of any units of bank and thrift organizations which enjoy federal deposit insurance beyond the scope of activities as of March 5, 1987. Significant criminal and civil penalties and private rights of action are provided.

2. In the second stage the new structure would be monitored for its success in limiting unfair bank advantages in non-banking businesses and containing the spread of the federal safety net.

3. Also in the second stage, to keep the process moving, a special Congressionally-led commission charged only with issues involving the separation of banking and non-banking operations and related issues involving regulatory oversight of financial markets and structures would examine the operation of the new structure and all of the implications of dissolving the separation between banking and commerce and would make recommendations for Congressional action.

If the firewalls work effectively and the policy considerations are resolved in favor of eliminating the wall between banking and commerce, then the next move would be to allow complete integration. In this manner, a method of limiting the direct coverage of the federal safety net would have been found as would a way for independent securities and other firms to emerge, survive and compete without the necessity of bank affiliation.

The legislation we are submitting undoubtedly is not perfect and cannot represent the exact views of every member of the Association, but is reflective of SIA's concerns as they have been developed to date. No doubt we will have additional thoughts later. Some of the material dealing with other business areas principally represents the thoughts of others.

We are pleased to have this opportunity to submit this draft legislation and look forward to continuing to work with the Committee.

cc: Joe Kelly

1412F

COMPREHENSIVE BANK INSULATION AND FAIR COMPETITION ACT OF 1988

Section by Section Analysis of Discussion Draft Dated February 2, 1988

Purposes: The purposes of the Act are stated to be the following:

> To minimize hazards to federally-insured financial institutions from securities, insurance and real estate activities; to develop and test structures for bank holding companies to prevent unfair competition in the delivery of certain securities, insurance and real estate services and the enlargement of risk to federally-insured financial institutions from non-banking activities, to further the continued existence of independent securities, insurance and real estate firms without the necessity of their being affiliated with banking organizations, to reassert Congressional control over federal financial policies and to establish functional regulation of financial institutions by providing that bank securities powers be carried on only in separate securities affiliates of a bank holding company subject to oversight by the Securities and Exchange Commission; and to establish a Financial Institutions Structural Review Commission to analyze, report and recommend to Congress concerning the future of banking institutions and their possible combining with other financial and commercial firms and the regulation of our national and international financial markets and other matters and to carry out such other duties as Congress may prescribe.

Section 1: Short Title

Section 1 provides that this Act be cited as the "Comprehensive Bank Insulation and Fair Competition Act of 1988."

TITLE I

NON-BANKING ACTIVITIES AND AFFILIATIONS OF BANKS

Title I restructures the securities, insurance and real estate activities of bank holding companies. Title I also prohibits member banks and banks and thrifts in bank holding companies from engaging in securities activities as defined, including underwriting, distribution, dealing in and placement of securities. In addition, it precludes member banks and banks and thrifts in bank holding companies from affiliating with any entity engaged in securities activities currently permitted by federal statute to be conducted directly by banks or by bank affiliates (e.g., investment advisory services, futures contracts, options, commodities, securities brokerage, gold and silver transactions, interest rate swaps or currency swaps other than for a bank's own risk management), except as expressly permitted under the Act. Under the Act, the conduct of such activities may continue or commence only through one or more separate securities affiliates of a bank holding company.

Title I places new limitations on the insurance powers of banks under the National Bank Act and of bank holding companies under the Bank Holding Company Act of 1956, and on the real estate activities of bank holding companies. The restrictions on securities, insurance and real estate activities conducted within bank holding company structures are made applicable to all units within a bank holding company. The Act does not grandfather securities activities approved by regulators that are inconsistent with its provisions; any bank or thrift that is an affiliate of a holding company or any affiliate thereof that engages in such proscribed activities is required to divest itself of those activities within a one-year period.

Section 101(a). This section amends section 16 of the Banking Act of 1933 to eliminate the authority of national banks to directly deal in or underwrite obligations of the United States or United States agencies, general obligations of states or their political subdivisions, and any other obligations national banks are currently permitted to deal in or underwrite. The authority of national banks to purchase and sell securities for customers on an agency basis is also eliminated, as is the authority to sell exchange, coin and bullion other than for the account of customers or for the bank's own risk management. This section also defines the securities activities in which national banks may not engage to include underwriting, distribution, dealing in, making markets in securities, private placement and public sale of securities, including mortgage-backed securities, investment advisory services with respect to securities, commodities transactions, and any other activities determined by the Securities and Exchange Commission to be securities activities as provided in the Act. A one year transition period is provided as to activities not previously prohibited. (Such activities are to be carried on only in securities affiliates as authorized under the Bank Holding Company Act.)

Section 101(b). This section amends Section 20 of the Banking Act of 1933 to preclude all affiliations between member banks and entities engaged in securities activities, except as specifically permitted for securities affiliates of bank holding companies under the Act. The "engaged principally" and "public sale" loopholes in the current version of Section 20 are eliminated. The scope of prohibited affiliations is expanded to include all securities activities as defined. A one year transition period is provided as to affiliations not previously prohibited.

Section 101(c). Section 101(c) bars the attempts of the Office of the Comptroller of the Currency to expand the insurance powers of national banks under Section 24(Seventh) of the National Bank Act. It continues to permit national banks to engage in credit-insurance activities. It does not permit the continuation of efforts by the Comptroller to permit national banks to sell and underwrite title and municipal-bond insurance. In addition, this provision ensures that traditional insurance products, such as variable life insurance, variable annuities and guaranteed interest contracts, are included within the scope of the insurance prohibitions of the National Bank Act, even though they may also be treated as securities products under different regulatory regimes.

Section 101(d). This section repeals a provision of 12 U.S.C. 24 permitting national banks to issue and sell Ginnie Mae certificates. (Such securities activities may continue to be conducted in securities affiliates of bank holding companies of national banks.)

Section 101(e). Section 101(e) amends Section 92 of the National Bank Act which permits the sale by national banks of insurance in small towns, by reiterating Congress' intent that the sale of insurance be confined to that small town.

Section 101(f). This section amends a provision limiting the authority of the Comptroller of the Currency to issue regulations and interpretations. The provision is broadened to prohibit issuance of directives or interpretations with respect to securities activities of national banks or affiliations of national banks with entities engaged in such activities.

Section 102(a). This section defines terms contained in the Act's amendments to the Bank Holding Company Act, including the definitions of bank affiliate, securities affiliate, securities activities, insurance and real estate activities.

Section 102(b). This section amends Section 4(a)(2) of the Bank Holding Company Act of 1956 to clarify that its restrictions on non-banking activities apply to all units within a bank holding company, and thereby closes the "South Dakota loophole." In addition, the Bank Holding Company Act of 1956 is amended to retain Congressional control of securities, insurance and real estate activities of bank holding companies by specifying that such activities do not constitute banking activities and by precluding the Federal Reserve Board from enlarging non-banking activities in those areas beyond what is specifically authorized by the Bank Holding Company Act, as amended. With respect to insurance, Section 102(b)&(d) are designed to demonstrate that the South Dakota loophole, as set forth in the Board's recent Merchants National Corporation Order, is contrary to congressional intent. Thus, the amending language establishes that all parts of a bank holding company, including its banking subsidiaries and any subsidiaries of those banks, are covered by Section 4 of the BHC Act.

Section 102(c). Section 102(c) amends Section 4(c) of the Bank Holding Company Act in order to ensure that the effect of Section 4(c)(8), which limits the insurance activities of bank holding companies, cannot be avoided by reliance on other portions of Section 4(c) that are not intended to provide any insurance authority in addition to that contained within Section 4(c)(8).

Section 102(d). This section limits the scope of insurance, real estate and securities activities of bank holding companies to what is prescribed by statute and precludes the Federal Reserve Board from authorizing such activities by regulation or order under the general "closely related to banking" criteria for non-banking activities for holding companies.

Section 102(e). Section 102(e)(1) is essentially consistent with the Board's current reading of Exemption C to Section 4(c)(8) by stating that insurance activities conducted under the "small town" exemption must be confined to the small town itself. However, this provision overrides the Board's interpretation of the small-town exemption in Section 4(c)(8)(C), which was recently upheld by a federal court of appeals, by placing in legislative language the intent expressed in Congress in 1982: that only bank holding companies with their principal place of banking business in a small town may invoke this exception. By contrast, the Board's interpretation permits even the largest bank holding companies to exploit this loophole.

Sections 102(e)(2)&(3) make clear the grandfather rights created by Section 4(c)(8) of the BHC Act are not transferable. This interpretation is consistent with the Board's reading of a separate grandfather clause set forth in Section 4(a)(2) of the BHC Act and with the Board's interpretation of Exemption G to Section 4(c)(8). The Board has, however, adopted a different reading of Exemption D to Section 4(c)(8). (The two grandfather clauses in Section 4(c)(8) differ in this respect. Exemption G permits a small number of bank holding companies engaged in insurance activities before January 1, 1971 to sell any kind of insurance in any place. Exemption D, which applies to a larger number of bank holding companies engaged in the insurance business as of May 1, 1982, contains both product and geographic limitations.) The language also bars a grandfathered bank holding company from expanding its grandfather privileges through its acquisition of a non-grandfathered bank holding company.

Section 102(f). This section authorizes securities affiliates of bank holding companies to (i) deal in or underwrite United States government and agency obligations, municipal general obligations and certain other obligations that national banks are currently permitted to deal in or underwrite directly, (ii) buy and sell exchange, coin, and bullion, (iii) engage in investment advisory, financial advisory or private placement activities, (iv) engage in securities brokerage, (v) engage in foreign exchange operations, (vi) engage in other securities activities permitted to national banks, member banks and bank holding companies as of March 5, 1987, (vii) engage in foreign securities operations as permitted and (viii) own a securities affiliate. Securities affiliates of national banks also are authorized to issue and sell Ginnie Mae certificates. In effect, virtually all existing securities powers of banks and of holding company affiliates are to be transferred to affiliates which are engaged exclusively in securities activities. Securities affiliates may be owned by a bank holding company in a sub-holding company structure made up of securities affiliates or may be owned directly by the bank holding company.

The isolation of securities powers in a securities affiliate distances securities operations from the federal safety net for two reasons: to reduce the threat that unsuccessful securities operations would necessitate a rescue by federal banking regulators and to separate securities operations from the special advantages that banks have (lower-cost funds, access to the Federal Reserve window, direct access to the payments system, favorable accounting and tax rules, freedom from supervision of the SEC in their securities activities, just to name a few). The isolation in the separate securities affiliate is accompanied by "firewall provisions," described below, to make the separation meaningful. No one knows whether firewalls internal to a banking organization can in fact work as a substitute for the separate ownership requirements of the Glass-Steagall Act; the restructuring will provide an opportunity to test the firewalls before exposing them to significant additional risks.

This section further provides that the Board of Governors of the Federal Reserve System must approve the establishment of any securities affiliate of a bank holding company. In deciding whether to approve an application or notification for the establishment of a securities affiliate, the Board is required to take into account the management experience and record of the holding company in securities activities as defined. The Board is also required to weigh the benefits of the securities affiliate to the public against possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. An exception to the public purpose test is provided for the transfer of existing operations from banks and other bank holding company subsidiaries.

This section further provides for funding and capital adequacy requirements for securities affiliates. Bank holding companies with securities affiliates may not have primary capital below six percent of assets, excluding the amount invested in securities affiliates. No funds from bank affiliates of holding companies or of other affiliates may be used to provide equity, debt or other credit to securities affiliates, except for earnings and dividends from non-bank subsidiaries of bank holding companies applied by the bank holding company to capitalize its securities affiliates. A formula for funding by a holding company of its securities affiliates is provided to ensure that securities affiliates will not receive funding indirectly from government-backed bank affiliates.

This section further provides various safety and fair competition "firewall" provisions to ensure that the business of securities affiliates will be separated from banking operations in a manner that will minimize risk to the federal safety net, conflicts of interest and unfair competition. No affiliate of a bank holding company may finance the purchase of securities underwritten or sold by a securities affiliate during the period of a distribution. To prevent one of the more flagrant abuses that the Glass-Steagall Act was designed to prevent, related banking organizations may not finance an issuer of securities underwritten by a securities affiliate to enable the issuer to pay principal of or interest or dividends on such securities.

To prevent tying and combining of credit with securities activities by affiliates of the bank holding company, bank holding company affiliates are precluded from extending credit or credit enhancement in connection with securities activities performed by another affiliate, and securities affiliates are prohibited from engaging in securities activities in any transaction in which another affiliate provides credit or credit enhancement. A securities affiliate shall not furnish any services consisting of underwriting, dealing in, private placement of or making a market in securities for its affiliates or for customers of its affiliates. A securities affiliate also shall not arrange financing to enable a debtor of a bank affiliate to repay an obligation to such bank.

It is understood that the anti-tying provisions of section 106 of the Bank Holding Company Act will prevent bank affiliates from requiring that their customers use the services of securities affiliates and vice versa. Sections 23A and 23B of the Federal Reserve Act are made applicable to all banks or thrifts within a bank holding company. It is understood that section 23B of the Federal Reserve Act will prevent the providing of bank services to a securities affiliate on terms more favorable than those provided to unaffiliated securities firms, precluding subsidization by a bank of a securities affiliate.

This section further provides that a bank affiliate shall not disclose to its securities affiliate nonpublic information obtained through access to the payments system and vice versa. No bank affiliate shall have a name or logo in common with a securities affiliate. No bank affiliate shall permit any of its securities affiliates to clear any transactions in securities through such bank unless independent securities firms are allowed the same services on the same conditions. Securities affiliates are required to maintain adequate capitalization as required by the SEC.

Officer, director and employee interlocks among bank affiliates and other affiliates of a holding company are generally prohibited, except for director interlocks between a securities affiliate and the holding company if the SEC approves such interlock. Reciprocal arrangements, whereby holding company affiliates would engage in transactions with unaffiliated securities affiliates that they could not engage in with their own securities affiliate in exchange for reciprocal treatment are prohibited. Bank affiliates are prohibited from handling credit facilities in a discriminatory manner with respect to independent securities firms. The firewall provisions are not applicable with respect to transactions between securities affiliates of a bank holding company.

This section also establishes real estate affiliates as a new classification of bank holding company affiliates. Such affiliates may engage in passive real estate investment and may continue for a five year period to engage in specified real estate services. Any affiliates that were engaged in other real estate services are subject to a five-year grandfather provision. A bank holding company with a real estate affiliate must maintain primary capital at six percent of assets, excluding investments in real estate affiliates. Prudential limitations and safeguard provisions with respect to transactions with real estate affiliates are also provided. Capital investment of a bank holding company in real estate affiliates is limited to five percent of the primary capital of the bank holding company. This section also contains certain provisions regarding extensions of credit by a bank to its real estate affiliate and to third parties associated with the real estate affiliate. A bank affiliate may not provide real estate services to any real estate affiliate and vice versa. The purchase or sale of real property or other assets between a bank and its real estate affiliate are prohibited. Reciprocal arrangements that would evade the prohibitions in the Act are also prohibited.

A bank and a real estate affiliate may not generally disclose nonpublic information between themselves. Officer, director or employee interlocks are prohibited between a real estate affiliate and a bank affiliate.

No bank shall arrange a credit facility or sell or purchase real property if the effect is to enable a debtor of a real estate affiliate to repay an obligation to such affiliate. No bank shall have a common name or logo with a real estate affiliate or a common use of business premises nor engage in common advertising.

This section also provides that the Federal Reserve Board must approve the acquisition by a bank holding company of a real estate affiliate. The Board's determination is subject to traditional standards and may be conditional.

This section also lists the real estate activities that are permissible for bank and nonbank affiliates of a holding company, which are generally limited to interests as a creditor in real property.

Section 103. This section amends the Federal Reserve Act to apply to member banks the restrictions on securities activities applicable to national banks and to provide that a member bank may not extend or fail to extend credit or services if the effect would be to treat securities firms not affiliated with a bank holding company less favorably than securities affiliates of bank holding companies.

Section 104. This section amends Section 18 of the Federal Deposit Insurance Act to provide that an insured bank which is an affiliate of a bank holding company shall only engage in activities that are permitted for bank affiliates of bank holding companies under the Bank Holding Company Act, and that the FDIC may not authorize an insured bank to conduct nonconforming activities.

Section 105. This section amends the National Housing Act to provide that insured institutions which are affiliates of bank holding companies shall only engage in activities that are permitted for bank affiliates of bank holding companies under the Bank Holding Company Act, and that the Federal Home Loan Bank Board may not authorize any nonconforming activities.

Section 106. This section provides that the bank and thrift regulatory authorities may not issue any regulations or opinions to the effect that particular activities do not constitute securities activities as defined in the Bank Holding Company Act, in order to prevent evasions of the structure established in the Act for the conduct of securities activities within securities affiliates of holding companies. The section provides that only the SEC may make such determinations with respect to securities activities.

Section 107. This section provides that the Chairmen of the SEC, the Federal Reserve Board, the FDIC and the Federal Home Loan Bank Board and the Comptroller of the Currency shall establish a coordinating body with respect to the transfer of securities activities to securities affiliates as required by the Act. The Chairman of the SEC is designated to chair the coordinating body. In addition, a general one-year transition period is provided with respect to activities or affiliations that become unlawful as a result of the enactment of the Act.

TITLE II

INTERNATIONAL PROVISIONS

Title II provides a framework for the conduct of foreign securities operations of U.S. banking organizations within the structure required for domestic securities operations. Since the foreign activities of bank holding companies can adversely affect federally-insured American banks and since international securities affiliates also enjoy the benefits of insured deposits and the federal safety net, the Act's structural protections should apply internationally. The conduct of securities activities abroad by member banks, Edge corporations, and subsidiaries of bank holding companies is administered under Regulation K of the Federal Reserve Board. There are more than 500 foreign branches of member banks and more than 1000 major subsidiaries of U.S. banking organizations that are governed by Regulation K. Securities activities abroad by U.S. banking organizations have assumed great significance over the past twenty years, especially in international money centers like London and Tokyo. Section 102(f) of the Act provides a comprehensive framework for placing all securities activities of U.S. banking organizations, both foreign and domestic, within a securities affiliate. This title provides for securities activities conducted abroad by United States banking organizations -- branches and subsidiaries of member banks (including Edge Corporations) and subsidiaries of bank holding companies -- to be conducted in the future only through securities affiliates of holding companies.

Section 201(a). This section provides that a member bank may not conduct securities activities outside the United States. It notes that such activities may be conducted by a securities affiliate of its affiliated bank holding company and that transactions between the bank and the securities affiliate will be subject to the safeguards that apply to transactions in the United States between securities affiliates and their affiliated banking organizations.

Section 201(b). This section provides that Edge Corporations, which are subsidiaries of U.S. banks that are licensed by the Federal Reserve Board and are authorized to conduct only international and foreign banking and foreign financial operations, may not conduct securities activities. This section also indicates that transactions between Edge Corporations and related securities affiliates of bank holding companies are subject to the safeguards in the Bill.

Section 201(c). This section provides that a bank holding company and its affiliates may not engage in securities activities abroad under the general provision for foreign activities in Section 4(c)(13) of the Bank Holding Company Act, but may do so only under the new structure provided in Section 4(c)(15) of the Bank Holding Company Act, as added by the Act.

Section 202. This section provides a transition rule, whereby any activities or affiliations that become unlawful as a result of the enactment of Title II may continue for a period of one year; the appropriate Federal regulatory agency may extend the period for up to an additional year if required for compliance with regulations of a foreign regulatory agency.

TITLE III

FUNCTIONAL REGULATION OF SECURITIES AFFILIATES BY THE SECURITIES AND EXCHANGE COMMISSION

Title III provides for functional regulation of securities affiliates by the Securities and Exchange Commission and, where appropriate, by the Commodity Futures Trading Commission. In addition, the Securities and Exchange Commission is specifically authorized to enforce the Act's restrictions on transactions between securities affiliates and other units of the bank holding company and prohibitions on differential credit treatment, and is given primary authority to determine what activities are securities activities or related activities that must be conducted within a securities affiliate if authorized by Congress.

Section 301. This section amends the Securities and Exchange Act of 1934 to indicate that securities affiliates of bank holding companies do not qualify for the bank exception from regulation by the SEC as broker-dealers.

Section 302. This section expressly renders securities affiliates, to the extent their activities involve matters within its jurisdiction, subject to regulation by the Commodity Futures Trading Commission.

Section 303. This section amends the securities laws to require that securities affiliates conform to all accounting principles and reporting requirements for brokers and dealers, including marking to market their securities portfolio. At present, banks have a special advantage in maintaining higher inventory values under special accounting rules that allow carrying inventory at cost, instead of the lower of cost or market value, as is required of independent securities firms. This section also generally provides that with respect to registration, reporting and other requirements, securities affiliates of banking organizations be treated as if they were not own by or affiliated with a bank bank holding company.

Section 304. This section amends the Securities Act of 1933. It empowers the SEC to assume responsibility for the oversight and regulation of securities activities within a securities affiliate and to enforce the inter-affiliate transaction restrictions of Title I of the Bill and the preferential credit treatment provisions of the Bill. It further authorizes the SEC to enforce Sections 23A and 23B of the Federal Reserve Act as applicable to transactions involving securities affiliates. In recognition of the continuous evolution of new types of financial instruments and transactions that present hazards identical or similar to those posed by securities, the SEC is also authorized to determine what activities constitute securities activities that must be conducted, if at all, within a securities affiliate.

Banks would be prohibited from engaging directly or through securities affiliates in any activities determined by the SEC to be securities activities absent Congressional action to permit such activities within a banking organization. In determining whether activities constitute securities activities, the SEC is directed to consider factors including whether such activities are susceptible to speculation, manipulation, control, or sudden fluctuations in value. The SEC is also authorized to exercise existing enforcement authority and to issue new rules to provide for separation of securities activities of securities affiliates from banking organizations to minimize risks to the federal safety net and the potential for unfair competition. The SEC is directed to establish procedures for the filing of notices and complaints by parties aggrieved by violations or nonenforcement of restrictions on securities activities. The authority of the Commodity Futures Trading Commission with respect to commodities transactions is preserved, as is the Federal Reserve Bank of New York's authority over transactions in government obligations.

TITLE IV

FINANCIAL INSTITUTIONS STRUCTURAL REVIEW COMMISSION

This title establishes a Financial Institutions Structural Review Commission to undertake a comprehensive review of the future of financial institutions in the United States, to determine, while the "firewall" between existing securities activities of banks and their federally supported depository and intermediation functions is being tested, the benefits and risks of any additional products or services or structural changes for such financial institutions. The principal task of the Commission will be to evaluate the role and function of American financial intermediaries in the United States and world economies. It shall examine the statutes and regulations affecting all financial intermediaries, including the relationship of commercial and investment banks and the role of so-called non-bank banks, to determine whether any changes are necessary in the laws to serve the national interest. It will also report on any needed changes in the federal deposit insurance system and payments system.

The Commission's members shall be drawn from the relevant Senate and House Committees and from heads of executive branch agencies in the financial services area as well as self regulatory bodies such as the CFTC, NASD, New York Stock Exchange and the National Association of Insurance Commissioners. The Commission shall be chaired by the Chairmen of the House and Senate Banking Committees and the House Energy and Commerce Committee. In addition, the Chairmen will appoint twenty non-voting advisory members who are prominent experts to assist the Commission in fulfilling its duties.

The Commission is given two years from its first meeting to deliver its report to the Congress and its recommendations for future action.

Once the Commission submits its report to Congress those members of the Commission who are also members of Congress will then terminate their status as members of the Commission, and the remaining members of the Commission shall carry out such oversight duties under current or new laws enacted by the Congress as Congress shall thereafter prescribe.

This title also provides the Commission the power to obtain personnel and services to carry out its mission.

TITLE V

ENFORCEMENT

This title provides substantial penalties for violations of the Act's restrictions on securities activities, reciprocal arrangements, unfair credit extension and inter-affiliate transactions, and encourages public and private enforcement of those restrictions.

Section 501. This section creates a civil private right of action in federal court against any violator of the bill's provisions, and authorizes judicial relief in the form of civil penalties or injunctions. In addition, a private right of action is authorized to challenge action or inaction by regulators with respect to the enforcement of the Act's requirements. The section gives the court authority to award costs of litigation, including attorneys' and expert witnesses' fees, to successful plaintiffs in suits brought against regulators.

Section 502. This section authorizes the imposition of substantial criminal fines against violators of the Act's provisions. The fines may be imposed in an amount of $250,000 or 1/100 of one per cent of a covered bank or thrift's minimum required capital for each day a violation continues, up to one per cent of such minimum required capital. Officers, directors, employees and agents who knowingly participate in a violation of the Act's provisions may be imprisoned for up to five years and fined $250,000 or double their annual compensation. Such officers, directors, employees and agents are also subject to criminal penalties for false entries under Title 18 of the U.S. Code.

Section 503. This section authorizes the imposition of civil fines by the appropriate regulatory agency or agencies in the identical amounts authorized for criminal fines against any violator of the Act's provisions or any officer, director, employee or agent who participates in any violation of the Act's provisions.

Section 504. This section provides for regulatory enforcement of the Act's requirements. The appropriate federal regulatory agency is authorized to bring regulatory proceedings against covered banks or thrifts, securities affiliates or holding companies with respect to such violations, and, if appropriate, to require divestiture within one year by the holding company of securities affiliates or bank affiliates. The agency is also authorized to impose additional capital requirements, to issue cease and desist orders, and to seek judicial enforcement of such orders.

Section 505. This section provides that the appropriate Federal regulatory agency shall be the Comptroller of the Currency in the case of national banks or District banks, the Federal Reserve Board in the case of banking holding companies and member banks (other than national banks), the FDIC in the case of covered insured non-member banks, the Federal Home Loan Bank Board in the case of covered insured institutions and the SEC in the case of securities affiliates.

TITLE VI

EFFECTIVE DATE

Section 601. This section provides that except as otherwise indicated in the Act, the effective date of the Act shall be March 5, 1987.

2279S/88

DISCUSSION DRAFT DATED FEBRUARY 2, 1988

100th CONGRESS
1st SESSION S. ____________________

IN THE SENATE OF THE UNITED STATES

Mr. ____________ introduced the following bill; which was read twice and referred to the Committees on ________________ and ____________________.

A BILL

To minimize hazards to federally-insured financial institutions from securities, insurance and real estate activities; to develop and test structures for bank holding companies to prevent unfair competition in the delivery of certain securities, insurance and real estate services and the enlargement of risk to federally-insured financial institutions from non-banking activities, to further the continued existence of independent securities, insurance and real estate firms without the necessity of their being affiliated with banking organizations, to reassert Congressional control over federal financial policies and to establish functional regulation of financial institutions by providing that bank securities powers be carried on only in separate securities affiliates of a bank holding company subject to oversight by the Securities and Exchange Commission; and to establish a Financial Institutions Structural Review Commission to analyze, report and recommend to Congress concerning the future of banking institutions and their possible combining with other financial and commercial firms and the regulation of our national and international financial markets and other matters and to carry out such other duties as Congress may prescribe.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

SECTION 1. SHORT TITLE; TABLE OF CONTENTS

(a) SHORT TITLE -- This Act may be cited as the "Comprehensive Bank Insulation and Fair Competition Act of 1988."

(b) TABLE OF CONTENTS --

TITLE I -- NON-BANKING ACTIVITIES AND AFFILIATIONS OF BANKS

Sec. 101 Amendments to the National Bank Act.
Sec. 102 Amendments to the Bank Holding Company Act.
Sec. 103 Amendment to the Federal Reserve Act.
Sec. 104 Amendments to the Federal Deposit Insurance Act.
Sec. 105 Amendments to the National Housing Act.
Sec. 106 Rulings on Securities Activities.
Sec. 107. Transition Procedures.

TITLE II -- INTERNATIONAL PROVISIONS -- SECURITIES ACTIVITIES ABROAD OF U.S. BANKING ORGANIZATIONS

Sec. 201 Conduct of Securities Activities Abroad by U.S. Banking Organizations through Securities Affiliates.
Sec. 202 Transition Rule.

TITLE III -- FUNCTIONAL REGULATION OF SECURITIES AFFILIATES BY THE SECURITIES AND EXCHANGE COMMISSION

Sec. 301 Amendments to the Securities Exchange Act of 1934 Providing For Securities Affiliate Regulation by the Securities and Exchange Commission as Broker-Dealer.
Sec. 302 Securities Affiliates Subject to Regulation by Commodity Futures Trading Commission.
Sec. 303 Accounting Principles, Reporting, and Registration Requirements for Securities Affiliates.
Sec. 304 Amendments to Securities Act of 1933 to Provide Special Powers of Securities and Exchange Commission With Respect to Securities Affiliates.

TITLE IV -- FINANCIAL INSTITUTIONS STRUCTURAL REVIEW COMMISSION

Sec. 401 Establishment and Composition of Commission.
Sec. 402 Functions of the Commission.
Sec. 403 Compensation of Commission Members
Sec. 404 Commission Staff
Sec. 405 Powers of the Commission
Sec. 406 Expenses of the Commission

TITLE V -- ENFORCEMENT

Sec. 501 Private Right of Action.
Sec. 502 Criminal Penalties.
Sec. 503 Civil Monetary Penalties.
Sec. 504 Regulatory Enforcement.
Sec. 505 Appropriate Federal Regulatory Agency

TITLE VI -- EFFECTIVE DATE

Sec. 601 Effective Date

TITLE I -- NON-BANKING ACTIVITIES AND AFFILIATIONS OF BANKS

SECTION 101. AMENDMENTS TO THE NATIONAL BANK ACT

(a) Section 16 of the Banking Act of 1933 (12 U.S.C. 24) is amended by striking paragraph Seventh and inserting in its place the following:

> "Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt; by receiving deposits; by loaning money on personal security; by buying and selling exchange, coin, and bullion for the account of customers or for its own interest rate and currency risk management; and by obtaining, issuing and circulating notes according to the provisions of this chapter. The association shall not engage in any securities activities as principal, broker or agent, other than financial advisory services provided in connection with a transaction in which the association or any bank that is an affiliate thereof within the meaning of section 1841 of this title provides no credit or credit enhancement in any manner. For purposes of this section, the term securities activities shall include (i) the underwriting, distribution, dealing in, making markets in, private placement and public sale of any stock, debt obligations, or other securities, including without limitation securities backed by or representing an interest in mortgages or other debt obligations originated or purchased by the association, or purchase or sale for the account of customers, other than as trustee, executor, administrator, or guardian of estates, of any stock, debt obligations, or other securities or securities-like products, (ii) other securities and securities-like activities, including without limitation investment advisory services with respect to securities, financial advisory services, the distribution, placement, purchase or sale of any contract with respect to securities, gold or silver, including without limitation futures contracts or option contracts, or the conduct of foreign exchange operations, interest rate swaps or currency swaps, other than for the account of customers or for purposes of the association's own interest rate or currency risk management (iii) commodities transactions and (iv) any other activities determined by the Securities and Exchange Commission to be securities activities as provided for in Section 304 of the Comprehensive Bank Insulation and Fair Competition Act of 1988: Provided, That the association may purchase for its own account, for investment and not for the purpose of dealing in, investment securities under

such further limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, for investment and not for the purpose of dealing in, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "securities" shall have the meaning given to that term in Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. §78c(a)(10)), and the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The investment securities described in this sentence only shall constitute "eligible securities" and, with respect to such eligible securities, the limitations and restrictions herein contained as to purchasing for its own account, and not for the purpose of dealing in, investment securities shall not apply: obligations of the United States, or general obligations of any State or of any political subdivision thereof, or obligations of the Washington Metropolitan Area Transit Authority which are guaranteed by the Secretary of Transportation under section 9 of the National Capital Transportation Act of 1969, [D.C. Code §1-2458], or obligations issued under authority of the Federal Farm Loan Act, as amended, or issued by the thirteen banks for cooperatives or any of them or the Federal Home Loan Banks, or obligations which are insured by the Secretary of Housing and Urban Development under title XI of the National Housing Act [12 U.S.C.A. §1749aaa et seq.] or obligations which are insured by the Secretary of Housing and Urban Development (hereafter in this sentence referred to as the "Secretary") pursuant to section 207 of the National Housing Act [12 U.S.C.A. §1713], if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States, or obligations, participations, or other instruments of or issued by the Federal National Mortgage Association or the Government National Mortgage Association, or mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to section 305 or section 306 of the Federal Home Loan Mortgage

Corporation Act [12 U.S.C.A. §1454 or 1455], or obligations of the Federal Financing Bank or obligations of the Environmental Financing Authority, or obligations or other instruments or securities of the Student Loan Marketing Association, or such obligations of any local public agency (as defined in section 110(h) of the Housing Act of 1949 [42 U.S.C.A. §1460(h)]) as are secured by an agreement between the local public agency and the Secretary in which the local public agency agrees to borrow from said Secretary, and said Secretary agrees to lend to said local public agency, monies in an aggregate amount which (together with any other monies irrevocably committed to the payment of interest on such obligations) will suffice to pay, when due, the interest on and all installments (including the final installment) of the principal of such obligations, which monies under the terms of said agreement are required to be used for such payments, or such obligations of a public housing agency (as defined in the United States Housing Act of 1937, as amended [42 U.S.C.A. §1437 et seq.]) as are secured (1) by an agreement between the public housing agency and the Secretary in which the public housing agency agrees to borrow from the Secretary, and the Secretary agrees to lend to the public housing agency, prior to the maturity of such obligations, monies in an amount which (together with any other monies irrevocably committed to the payment of interest on such obligations) will suffice to pay the principal of such obligations with interest to maturity thereon, which monies under the terms of said agreement are required to be used for the purpose of paying the principal of and the interest on such obligations at their maturity, (2) by a pledge of annual contributions under an annual contributions contract between such housing agency and the Secretary if such contract shall contain the covenant by the Secretary which is authorized by subsection (g) of section 6 of the United States Housing Act of 1937, as amended [42 U.S.C.A §1437d(g)], and if the maximum sum and the maximum period specified in such contract pursuant to said subsection 6(g) [42 U.S.C.A. §1437d(g)], shall not be less than the annual amount and the period for payment which are requisite to provide for the payment when due of all installments of principal and interest on such obligations, or (3) by a pledge of both annual contributions under an annual contributions contract containing the covenant by the Secretary which is authorized by section 6(g) of the United States Housing Act of 1937 [42 U.S.C.A. §1437d(g)], and a loan under an agreement between the local public housing agency and the Secretary in which the public housing agency agrees to borrow from the Secretary and the Secretary agrees to lend to the public housing agency, prior to the maturity of the obligations involved, moneys in an amount which (together with any other moneys irrevocably committed under the annual contributions contract to the payment of principal and interest on such obligations) will suffice to provide for the payment when due of all installments of principal and interest on such obligations, which moneys under the terms of the agreement are required to be used for the purpose of paying the principal and interest on such obligations at their maturity: Provided, That in carrying on the business commonly known as the safe-deposit business the association shall not invest in the capital stock of a corporation organized under the law of any State to conduct a safe-deposit business in an amount in excess of 15 per centum of the capital stock of the association actually paid in and unimpaired and 15 per centum of its unimpaired surplus. Notwithstanding any other provision in this paragraph, the association may purchase for its own account, for investment and not for the purpose of dealing in, shares of stock issued by a corporation authorized to be created pursuant to title IX of the Housing and Urban Development Act of 1968 [42 U.S.C.A. §3931 et seq.], and may make investments in a partnership, limited partnership, or joint venture formed pursuant to section 907(a) or 907(c) of that Act [42 U.S.C.A. §§3937(a) or 3937(c)]. Notwithstanding any other provision of this paragraph, the association may purchase for its own account, for investment and not for the purpose of dealing in, shares of stock issued by any State housing corporation incorporated in the State in which the association is located and may make investments in loans and commitments for loans to any such corporation: Provided, That in no event shall the total amount of such stock held for its own account and such investments in loans and commitments made by the association exceed at any time 5 per centum of its capital stock actually paid in and unimpaired plus 5 per centum of its unimpaired surplus fund. Notwithstanding any other provision in this paragraph, the association may purchase for its own account, for investment and not for the purose of dealing in, shares of stock issued by a corporation organized solely for the purpose of making loans to farmers and ranchers for agricultural purposes, including the breeding, raising, fattening, or marketing of livestock. However, unless the association owns at least 80 per centum of the stock of such agricultural credit corporation the amount invested by the association at any one time in the stock of such corporation shall not exceed 20 per centum of the unimpaired capital and surplus of the association: Provided further, That notwithstanding any other provision of this paragraph, the association may purchase for its own account, for investment and not for the purpose of dealing in, shares of a bank insured by the Federal Deposit Insurance Corporation or a holding company which owns or controls such an insured bank if the stock of such bank or company is owned exclusively (except to the extent directors' qualifying shares are required by law) by depository institutions and such bank or company and all subsidiaries thereof are engaged exclusively in providing services for other depository institutions and their officers, directors, and employees, but in no event shall the total amount of such stock held by the association in any bank or holding company exceed at any time 10 per centum of the association's capital stock and paid in and unimpaired surplus and in no event shall the purchase of such stock result in an association's acquiring more than 5 per centum of any class of voting securities of such bank or company. Except for the requirement that such securities be purchased for the association's own account for investment and not for the purpose of dealing in, the limitations and restrictions contained in this paragraph as to an association purchasing for its own account investment securities shall not apply to securities that (A) are offered and sold pursuant to section 4(5) of the Securities Act of 1933 (15 U.S.C. 77d(5)); or (B) are mortgage related securities (as that term is defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), subject to such further limitations and restrictions as the Comptroller of the Currency may prescribe. As provided in Section 304 of the Comprehensive Bank Insulation and Fair Competition Act of 1988, the Securities and Exchange Commission shall have exclusive authority to issue interpretations with respect to an association's authority to purchase a security for its own account pursuant to this paragraph; Provided, That nothing in this paragraph shall require an association to dispose of any securities lawfully held by it prior to the date of enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988. An activity that was lawfully conducted by an association prior to March 5, 1987 and that as a result of the enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988 may not be conducted by an association may continue for a period of one year after such enactment."

(b) Section 20 of the Banking Act of 1933 (12 U.S.C. 377) is amended by striking the first paragraph thereof and inserting in its place the following:

"After one year from June 16, 1933, or, with respect to affiliations not prohibited hereunder prior to March 5, 1987 and expressly authorized prior to such date, after one year from the date of enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988, no member bank shall be affiliated in any manner described in section 1841(k) of this title with any corporation, association, business trust, or other similar organization engaged in securities activities as defined in Section 24 of this title; provided, that nothing in this paragraph shall prohibit any affiliation permitted under Section 4(c)(15) of the Bank Holding Company Act of 1956 (12 U.S.C.

§1843(c)(15)); provided further, that nothing in this paragraph shall apply to any such organization which shall have been placed in formal liquidation and which shall transact no business except such as may be incidental to the liquidation of its affairs."

(c) Section 5136 of the Revised Statutes (12 U.S.C. 24) is further amended --

(1) by inserting "(a) IN GENERAL -- immediately before "Upon duly making and filing"; and

(2) by adding at the end thereof the following new subsection:

"(b) LIMITATION ON INSURANCE POWERS -- No national bank, or any subsidiary (as defined in Section 2(d) of the Bank Holding Company Act of 1956), may provide insurance as a principal, agent, or broker except to the extent that the insurance is limited to assuring the repayment of the outstanding balance due on any specific extension of credit by the national bank in the event of the death, disability, or involuntary unemployment of the debtor. For the purposes of this Act, the term "insurance" means any product, or its functional equivalent, that is (i) subject to supervision or regulation by an insurance commissioner, or a similar official or agency, of any state or territory or the District of Columbia, and issued by any company organized as an insurance company that is subject to supervision or regulation by an insurance commissioner, or a similar official or agency, of any state or territory or the District of Columbia, or (ii) any other existing or future coverages, such as crop insurance or flood insurance, issued by the United States government, or any agency or instrumentality thereof or any government corporation, except for insurance provided by the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation."

(d) Paragraph Ninth of Section 5136 of the Revised Statutes is stricken.

(e) Section 5239 of the Revised Statutes (12 U.S.C. 92) is amended by inserting, "so long as such insurance activities are confined to the place in which the national banking association is located and doing business and the population of such place does not exceed five thousand inhabitants, as shown by the last decennial census" after "such company" and before the semicolon.

(f) Section 5239A of the Revised Statutes (12 U.S.C. 93a) is amended by striking the text thereof and substituting in its place the following:

"Except to the extent that authority to issue such rules, regulations, orders or interpretations has been expressly and exclusively granted to another regulatory agency, the Comptroller of the Currency is authorized to issue rules, regulations, interpretations and orders to carry out the responsibilities of the office, except that the Comptroller of the Currency shall have no such authority with respect to section 36 of this title or with respect to securities activities of National Banks or affiliations of National Banks with entities engaged in such activities or transactions of National Banks with holding company affiliates thereof."

SECTION 102. AMENDMENTS TO THE BANK HOLDING COMPANY ACT

(a) Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) is amended by adding the following new subsections:

"(n) SECURITIES AFFILIATE --

(1) the term "securities affiliate" means any company that --

(A) is engaged solely pursuant to section 4(c)(15) of this Act in one or more of the activities described in subparagraph (A) of that subsection; and

(B) is directly owned by a bank holding company and is engaged solely in securities activities or in the business of owning one or more securities affiliates and is itself registered as, or its subsidiaries are registered as, a broker or dealer under the Securities Exchange Act of 1934 or as an investment adviser under the Investment Advisers Act of 1940 and with either the New York Stock Exchange or the National Association of Securities Dealers, if an independent securities firm engaged in identical activities would be required to so register.

(2) the term "securities affiliate" shall include direct subsidiaries of a bank holding company qualifying as securities affiliates and securities affiliates owned by securities affiliates."

"(o) INSURANCE -- For the purposes of this Act, the term "insurance" means any product, or its functional equivalent, that is (i) subject to supervision or regulation by an insurance commissioner, or a similar official or agency, of any state or territory or the District of Columbia, and issued by any company organized as an insurance company that is subject to supervision or regulation by an insurance commissioner, or a similar official or agency, of any state or territory or the District of Columbia, or (ii) any other existing or future coverages, such as crop insurance or flood insurance, issued by the United States government, or any agency or instrumentality thereof or any government corporation, except for insurance provided by the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation."

"(p) BANK AFFILIATE -- The term "bank affiliate" means any bank or thrift institution which is an affiliate of a bank holding company."

"(q) SECURITIES ACTIVITIES -- The term "securities activities" means (i) the underwriting, distribution, dealing in, making markets in, private placement and public sale of any stock, debt obligations, or other securities, including without limitation securities backed by or representing an interest in mortgages or other debt obligations originated or purchased by the association, or purchase or sale for the account of customers, other than as trustee, executor, administrator, or guardian of estates, of any stock, debt obligations, or other securities or securities-like products, (ii) other securities and securities-like activities, including without limitation investment advisory services with respect to securities, the distribution, placement, purchase or sale of any contract with respect to securities, gold or silver, including without limitation futures contracts or option contracts, the conduct of foreign exchange operations, interest rate swaps or currency swaps, other than for the purposes of the bank affiliate's own interest rate or currency risk management, and financial advisory services provided in connection with a transaction in which any bank affiliate of the bank holding company provides credit or credit enhancement in any manner (iii) commodities transactions and (iv) any other activities determined by the Securities and Exchange Commission to be securities activities as provided for in Section 304 of the Comprehensive Bank Insulation and Fair Competition Act of 1988.

"(r) DIRECTLY OR INDIRECTLY -- The term "directly or indirectly" when used in reference to activities or investments of an organization means activities or investments of one or more organizations which are affiliates of such organization."

"(s) EXTENSION OF CREDIT -- The term "extension of credit" includes any liability to advance funds to or on behalf of a person pursuant to a contractual commitment, including, but not limited to, a letter of credit, standby letter of credit, asset purchase agreement, indemnity or guaranty."

"(t) PASSIVE REAL ESTATE INVESTMENT -- The term "passive real estate investment" means any real estate investment by a real estate affiliate:

"(1) Which is conducted through passive, nonmanagerial investments in joint ventures or partnership with third parties that are not affiliated with the real estate affiliate and that do not share common officers, directors or employees with the real estate affiliate; and

"(2) The real estate investment was not initiated by such real estate affiliate but rather by a non-affiliated company."

"(u) REAL ESTATE ACTIVITIES -- The term "real estate activities" means engaging in any real estate investment or engaging in or providing any real estate services."

"(v) REAL ESTATE AFFILIATE --

(1) the term "real estate affiliate" means any company that --

(A) is engaged solely pursuant to section 4(c)(16) of this Act in one or more of the activities described in subparagraphs (A)(i) and (ii) of that subsection or is engaged solely in the business of owning one or more real estate affiliates; and

(B) is directly owned by a bank holding company.

(2) the term "real estate affiliate" shall include direct subsidiaries of a bank holding company qualifying as real estate affiliate and real estate affiliates owned by real estate affiliates."

"(w) REAL ESTATE INVESTMENT -- The term "real estate investment" means the direct or indirect ownership of any equity interest in real property whether in the form of partnership, joint venture or otherwise."

"(x) REAL ESTATE SERVICES -- The term "real estate services" means:

"(1) Appraisal of real property for a fee;

"(2) Serving as a sales agent or broker of, or otherwise listing, marketing or representing a purchaser, seller, prospective purchaser, prospective seller, lessor, lessee, prospective lessor, or prospective lessee of, residential, industrial, farm or commercial real property for a fee; or

"(3) Management or development of real property other than real property owned, controlled, leased or occupied by the company performing such management or development."

"(y) REAL PROPERTY -- The term "real property" means real property together with any improvements or fixtures thereto."

"(z) RECIPROCAL ARRANGEMENT -- The term "reciprocal arrangement" means any agreement, informal or formal, between two or more bank holding companies or their affiliates, whereby one such company or affiliate thereof, agrees to take, with respect to another such company or affiliate thereof, an action it would be proscribed from taking with respect to its own company, or its affiliate in exchange for the agreement of another company or affiliate thereof to undertake a similar action."

"(aa) SECURITIES -- The term "securities" shall have the same meaning given to that term in Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)."

(b) Section 4(a)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(a)(2)) is amended:

(i) by striking out "or engage in any activities other than" and inserting in lieu thereof "or engage, directly or indirectly through any bank or non-bank subsidiary or affiliate, in any activities other than";

(ii) by striking out the words "paragraph (8)" in subparagraph (B) thereof and inserting in lieu thereof the words "paragraphs (8), (15) and (16)"; and

(iii) by inserting at the end of the first sentence thereof, the following: "; Provided further, That securities activities, insurance and real estate activities shall not be deemed to constitute managing or controlling banks or banking activities to be carried on within a bank or thrift institution."

(c) Section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) is amended by inserting, after "bank holding company, apply to" the following clause: "the following, provided, however, that no bank holding company, or any subsidiary or affiliate thereof, except as permitted by paragraph (8) of this section, shall provide insurance as principal, agent or broker".

(d) Section 4(c)(8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(8)) is amended by striking the text prior to subparagraph (A) thereof and inserting in its place the following:

> "(8) shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking and managing or controlling banks as to be a proper incident thereto, but for purposes of this subsection it is not closely related to banking or managing or controlling banks for a bank holding company, or any subsidiary or affiliate thereof, to engage in securities activities, except as expressly permitted under subsection (c)(15) of this section, or to engage in real estate activities, except as expressly permitted under subsection (c)(16) of this section, or to provide insurance as a principal, agent or broker except".

(e) Section 4(c)(8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(8)) is further amended:

> (1) by striking out subparagraph (C) of subsection (c)(8) and inserting in lieu thereof the following new subparagraph: "(C) any insurance sold by a bank holding company that has its principal place of banking business (that is the place where the total bank deposits of the entire bank holding company system is the greatest) in a place that has a population not exceeding five thousand (as shown by the preceding decennial census) so long as such insurance activities are confined to a place that (i) has a population not exceeding five thousand (as shown by the last preceding decennial census), or (ii) the bank holding company, after notice and opportunity for a hearing, demonstrates has inadequate insurance agency facilities;"
>
> (2) in subsection (c)(8)(D), by inserting immediately before the semicolon at the end the following: ", but, in order to ensure that privileges bestowed by this subparagraph may not be transferred, (i) if control of any bank holding company engaged in insurance agency activities pursuant to this subparagraph, or the subsidiary or affiliate of such company that is engaged in such activities, is acquired by any other company and such acquiring company is, becomes, or becomes affiliated with,

a bank holding company (by reason of such acquisition or at any time subsequent to such acquisition), all privileges bestowed upon the acquired company, subsidiary, or affiliate by this subparagraph shall cease immediately and (ii) no company, subsidiary or affiliate upon which privileges have been bestowed by this subparagraph shall extend those privileges to any company, subsidiary, or affiliate, or to any corporate successor, acquired after May 1, 1982;" and

(3) in subsection (c)(8)(G), by inserting immediately before the period at the end the following: ", but, in order to ensure that the privileges bestowed by this subparagraph may not be transferred, (i) if control of any bank holding company engaged in insurance agency activities pursuant to this subparagraph, or the subsidiary or affiliate of such company that is engaged in such activities, is acquired (directly or indirectly) by any other company and such acquiring company is, becomes, or becomes affiliated with, a bank holding company (by reason of such acquisition or at any time subsequent to such acquisition) all privileges bestowed upon the acquired company, subsidiary or affiliate by this subparagraph shall immediately cease and (ii) no company, subsidiary or affiliate upon which privileges have been bestowed by this subparagraph shall extend those privileges to any company, subsidiary, or affiliate, or to any corporate successor, acquired after January 1, 1971."

(f) Section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) is amended by adding at the end thereof the following new paragraphs:

"(15)(A) SECURITIES AFFILIATES -- shares of a securities affiliate which may, in accordance with this paragraph --

"(i) deal in or underwrite eligible securities as defined in paragraph Seventh of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), as amended by the Comprehensive Bank Insulation and Fair Competition Act of 1988, and obligations issued by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank or the Inter-American Investment Corporation, obligations issued by any State or political subdivision or any agency or political subdivision for housing, universities, or dormitory purposes, which are at the time eligible for purchase by a national bank for its own account, and other obligations issued by the Tennessee Valley Authority or by the United States Postal Service;

"(ii) buy and sell exchange, coin, and bullion;

"(iii) engage in such investment advisory activities, financial advisory services and private placement activities as a bank or bank affiliate lawfully could conduct prior to March 5, 1987;

"(iv) purchase and sell securities and stock without recourse, solely upon the order, and for the account of, customers, and not for its own account;

"(v) engage in foreign exchange operations;

"(vi) engage in such securities activities not described in clauses (i) through (v) hereof as a bank or bank affiliate lawfully could conduct prior to March 5, 1987;

"(vii) engage in such foreign securities underwriting activities or such other foreign securities activities as a bank under Section 25 or corporation organized under Section 25(a) of the Federal Reserve Act (12 U.S.C. 611 et. seq.) or an affiliate lawfully could conduct pursuant to subsection 4(c)(13) prior to the enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988;

"(viii) if such securities affiliate is affiliated with a national bank, issue and sell securities which are guaranteed pursuant to 12 U.S.C. 1721(g); and

"(ix) own a securities affiliate."

"(B) APPLICATION REQUIREMENTS --

"(i) A bank holding company shall not acquire shares of a securities affiliate pursuant to this paragraph without the Board's prior approval.

"(ii) The Board shall not approve a notification or an application under this paragraph unless the Board is satisfied that the bank holding company and a securities affiliate possess the managerial and financial resources to supervise and conduct the activities described in subparagraph (A) of this paragraph without unduly increasing risk for the bank holding company and its bank and thrift institution affiliates. Maintaining the safety and soundness of the bank holding company shall be a principal consideration. In making its determination, the Board shall take into account the experience of management and its record of successfully managing the bank holding company and of activities that are the same as or similar to those authorized for securities affiliates under subparagraph (A) of this paragraph. In addition, in determining whether to approve an application under this paragraph, the Board shall consider whether the performance of the activity or activities by the securities affiliate described in the notice or application can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices; provided that any application submitted within one year of the date of the enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988 by a bank holding company which on the date of such enactment was carrying on activities enumerated in subsection 4(c)(15) and seeks to conduct such activities in a securities affiliate need not qualify under the requirements of this clause.

(iii) No securities affiliate shall commence operations until the adequacy of its capital, personnel, systems and controls has been certified by the Securities and Exchange Commission."

"(C) SECURITIES ACTIVITIES APPROVED UNDER PARAGRAPH (8) --

"(i) No bank holding company may engage in, or retain the shares of any company engaged in, or control directly or indirectly a company engaged in, securities activities on the basis of the Board's prior approval of an application under paragraph (8) of this subsection. A bank holding company that is engaged in, owns shares of any company engaged in, or controls directly or indirectly a company engaged in such activities pursuant to an application under paragraph (8) of this subsection approved by the Board prior to March 5, 1987 may continue to engage in, own shares of a company, or control directly or indirectly a company engaged in such activities for a period of one year from the date of enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988.

"(ii) The Board shall, after the date of enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988, have no authority to accept or approve any notice by a bank holding company under paragraph (8) of this subsection to engage in or acquire the shares of a company engaged in to any extent whatsoever or which controls directly or indirectly in whole or in part a company engaged in, securities activities."

"(D) FUNDING AND CAPITAL ADEQUACY --

"(i) (a) INITIAL CAPITALIZATION OF SECURITIES AFFILIATES BY BANK HOLDING COMPANY -- A bank holding company may provide to any of its securities affiliates, consistent with its obligation to be a source of strength for its subsidiary banks and without reducing its primary capital below six percent of assets, excluding amounts invested in securities affiliates, or, if higher, the capital required by the Federal Reserve Board, debt and permanent equity capital prior to the commencement of operations of any such securities affiliates. Any debt or other credit provided to or for the benefit of securities affiliates provided by a bank holding company prior to the commencement of operations of the securities affiliates shall be repaid by a securities affiliate to the bank holding company no later than the date of commencement of operations of any such securities affiliate. Securities affiliates shall be capitalized as if they were to operate independently or as a group of securities affiliates.

" (b) SUBSEQUENT CAPITALIZATION, EXTENSIONS OF CREDIT, AND TRANSFERS OF ASSETS BY BANK HOLDING COMPANY--After the commencement of operations of any securities affiliate thereof, the bank holding company may provide permanent equity and debt and other credit to such securities affiliate, subject to the conditions set forth in the first sentence of subparagraph (a) and the following additional requirements:

"(1) (A) No dividends, earnings, credit or assets obtained from its bank affiliates, directly or indirectly, may be used to provide funds of any kind to securities affiliates, to repay debt incurred or issued by, or repurchase equity securities issued by, the holding company to provide funds to securities affiliates, or otherwise to benefit securities affiliates in any manner.

(B) No credit or assets obtained from subsidiaries other than securities affiliates, directly or indirectly, may be used to provide funds of any kind to securities affiliates.

"(2) Funding provided by a holding company to its securities affiliates in a any fiscal year shall not exceed the total of (A) the preceding fiscal year's (i) dividends and earnings from subsidiaries other than bank affiliates, plus (ii) other revenue earned by the bank holding company from its own assets and business from third parties, minus (iii) dividends paid to stockholders of the bank holding company plus, (B) funds raised in that fiscal year through sale of debt and equity securities of the bank holding company. A bank holding company, directly or indirectly, shall not utilize the funds, assets or credit of any bank affiliate to support or benefit any securities affiliate.

"(ii) (a) CAPITALIZATION, EXTENSIONS OF CREDIT AND TRANSFERS OF ASSETS BY HOLDING COMPANY AFFILIATES --Other than as specifically permitted in subparagraph D(i)(b) of this paragraph, no bank holding company, no bank affiliate or other affiliate of the holding company shall make, directly or indirectly through any affiliate (including its bank holding company) or third party, any debt or equity investment in, or extend credit or transfer assets to or for the benefit of, any securities affiliate thereof other than non-financial assets transferred at market value in the ordinary course of business, and other than in connection with the transfer of securities activities, including the assets and liabilities associated with on-going operations, in connection with the commencement of operations under this paragraph."

"(b) No affiliate of a bank holding company shall, directly or indirectly:

"(1) extend credit in any manner to its securities affiliates;

"(2) purchase for its own account assets of its securities affiliates;

"(3) issue a guaranty, acceptance, or letter of credit, including an endorsement or standby letter of credit, to or for the benefit of its securities affiliates;

"(4) extend credit in any manner to any investment company advised by its securities affiliate;

"(5) extend credit, or issue or enter into a standby letter of credit, asset purchase agreement, indemnity, guaranty, insurance which is the functional equivalent of a credit facility, or other facility, for the purpose of enhancing the marketability of a securities issue underwritten, placed or otherwise distributed by its securities affiliate;

"(6) knowingly extend or arrange for the extension of credit, directly or indirectly, secured by or for the purpose of purchasing any security while, or for 30 days after, that security is the subject of a distribution in which any of its securities affiliates participates as an underwriter or a member of a selling group; or

"(7) extend credit or arrange for the extension of credit to an issuer of securities underwritten by any of its securities affiliates for the purpose of paying the principal of those securities or interest or dividends on those securities; or

"(8) extend credit or arrange for the extension of credit, where such action has the effect of enabling a debtor of its securities affiliate to repay an obligation to such securities affiliate."

"(c) No bank holding company shall extend credit in transactions described in subparagraphs (b)(4) through (8) of this subsection.

"(E) FUNDING BANKING ASSETS --No securities affiliate shall, directly or indirectly, extend credit, arrange for the extension of credit, underwrite securities, or issue securities if such action has the effect of enabling a debtor of a bank affiliate thereof to repay an obligation to such bank affiliate."

"(F) TYING AND COMBINING OF CREDIT WITH SERVICES AND PRODUCTS --Notwithstanding any other provision of this Act, neither a bank affiliate nor any affiliate thereof may, directly or indirectly, extend credit in any manner or issue a guaranty, acceptance, or letter of credit, including an endorsement, standby letter of credit or other credit facility in connection with, in combination with or in anticipation of any transaction in which a securities affiliate thereof or any affiliate thereof performs or provides services or products constituting securities activities. Neither a securities affiliate nor any affiliate thereof shall perform or provide services constituting securities activities in connection with, in combination with or in anticipation of any transaction in which a bank affiliate thereof or any affiliate thereof directly or indirectly extends credit in any manner or issues a guaranty, acceptance, or letter of credit, including an endorsement, standby letter of credit or other crecit facility. The provisions of this clause shall not preclude a securities affiliate from extending credit or providing a credit facility or engaging in securities activities in connection with, in combination with or in anticipation of a transaction in which another securities affiliate thereof engages in securities activities. For the purposes of this clause, the term "securities activities" shall be defined as such term is defined in section 24 of this title."

"(G) SERVICES BY SECURITIES AFFILIATE -- A securities affiliate shall not, directly or indirectly, furnish any services to or perform any services for its affiliates consisting of the following:

(i) underwriting or distributing securities of such affiliates or securities secured by or representing an interest in mortgages or other obligations originated or acquired by such affiliates; or

(ii) underwriting or arranging the private placement of or dealing or making a market in securities for the account of such affiliates or of customers of such affiliates."

"(H) NONPUBLIC INFORMATION -- No bank affiliate, directly or indirectly, shall disclose to any of its securities affiliates, nor shall a securities affiliate, directly or indirectly, disclose to any of its bank affiliates, or share any nonpublic customer information obtained by access to the payments system."

"(I) IDENTIFICATION -- No bank affiliate shall have a name or graphic identification in common with a securities affiliate, or indicate in any advertising or other public media the fact of affiliation with any securities affiliate or share public or private premises with any of its securities affiliates; name and graphic identification in common with its bank holding company is permitted for a securities affiliate if there is no common name or graphic identification between the bank holding company and any bank affiliate."

"(J) CLEARING -- No bank affiliate with direct access to the Fedwire or CHIPS or other clearance systems shall permit any of its securities affiliates to clear any transactions in securities through such bank unless securities firms not affiliated with banks are permitted to clear transactions in securities through such bank affiliate at the same prices, priorities, terms and conditions."

"(K) INTERLOCKS -- No officer, director or employee of a securities affiliate shall serve at the same time as an officer, director, or employee of any other affiliate; provided, with the prior approval of the Securities and Exchange Commission, a person may serve at the same time as an officer, director, or employee of the bank holding company and as a director of the securities affiliate."

"(L) PROHIBITION ON RECIPROCAL ARRANGEMENTS -- Any reciprocal arrangements are prohibited. The Securities and Exchange Commission shall have the authority to enforce this provision, including the right to issue regulations, orders and rulings and to require reports and certifications."

"(M) PROHIBITION ON DISCRIMINATORY CREDIT TREATMENT -- No bank affiliate shall, directly or indirectly, extend or deny credit or services or vary the terms or conditions thereof if the effect of such action would be to treat securities firms not affiliated with a bank holding company less favorably than securities firms affiliated with a bank holding company."

"(N) OTHER INTER-AFFILIATE TRANSACTIONS -- The provisions of sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c-1) shall be applicable to every bank affiliate in the same manner and to the same extent as if such bank affiliate were a member bank, and for this purpose, any affiliate of a bank affiliate which would be an affiliate for purposes of such sections 23A and 23B if such bank affiliate were a member bank shall be deemed to be an affiliate of such bank affiliate for purposes of such sections 23A and 23B."

"(O) CAPITAL ADEQUACY -- A securities affiliate shall maintain capital at levels adequate to conduct the activities in which it is engaged. The Securities and Exchange Commission shall be responsible for specifying such capital requirements."

"(F) TRANSACTIONS BETWEEN SECURITIES AFFILIATES -- The provisions of this paragraph shall not apply to transactions between or among securities affiliates of a bank holding company."

"16(A) REAL ESTATE AFFILIATES -- shares of a real estate affiliate which may, in accordance with this paragraph -

(i) engage in or provide passive real estate investment; and

(ii) engage in or provide real estate services of a type which the company or an affiliated insured bank was lawfully engaged in or providing on the date of introduction of the Comprehensive Bank Insulation and Fair Competition Act of 1988; provided that this subsection 16(A)(ii) shall only apply to and be in effect for a period ending on January 25, 1993.

"(B) CAPITAL REQUIREMENTS -- Any bank holding company that is affiliated with a real estate affiliate shall maintain primary capital of six percent of assets or such higher level required by regulation by the Board; provided that, in determining a bank holding company's consolidated capital for the purpose of calculating the amount of primary capital required, 100 percent of the amount of investment in real estate affiliates shall be excluded; and provided further that the Board may require, generally or in the case of any particular bank holding company, a higher level of primary capital."

"(C) TRANSACTIONS WITH REAL ESTATE AFFILIATES --

"(i) CAPITAL INVESTMENT -- No bank holding company that is affiliated with a real estate affiliate shall invest, in the aggregate, in the capital stock, obligations other than extensions of credit, or other securities of all affiliated real estate affiliates an amount in excess of five percent of the primary capital, as established by the Federal Reserve Board, of the bank holding company.

"(ii) EXTENSIONS OF CREDIT -- No affiliate of a bank holding company shall make, directly or indirectly:

"(a) Any extensions of credit (i) to a real estate affiliate thereof which is engaged in or provides real estate services to any third party or (ii) to any third party in connection with a transaction from which a real estate affiliate thereof would derive compensation for real estate services; or

"(b) Any extensions of credit (i) to a real estate affiliate thereof which is engaged in real estate investment, (ii) to any third party for the purpose of acquiring any interest in any real property in which such a real estate affiliate has a direct or indirect interest, or (iii) to any partner, co-venturer or other entity with which such a real estate affiliate is associated by joint venture, contract or otherwise unless the extension of credit is consistent with safe and sound banking practices, is made on substantially the same terms, including those governing interest and collateral, as those prevailing at the time for comparable transactions with unaffiliated persons, and does not involve more than the normal risk of repayment or present other unfavorable features."

"(iii) PROVISION OF SERVICES -- No bank affiliate shall directly or indirectly provide any real estate services to any real estate affiliate thereof or purchase or otherwise obtain real estate services from such a real estate affiliate."

"(iv) PURCHASE OR SALE OF ASSETS -- No affiliate of a bank holding company shall purchase or lease real property or other assets or any interest therein from or sell or lease real property or other assets or any interest therein to any real estate affiliate thereof; provided that a bank affiliate or affiliate thereof may acquire from such a real estate affiliate those interests and rights described in subsections D (ii) or (viii) hereof in connection with an extension of credit to such a real estate affiliate which is otherwise authorized by this section."

"(v) RECIPROCAL ARRANGEMENTS -- Reciprocal arrangements shall be prohibited."

"(vi) NONPUBLIC INFORMATION -- No bank affiliate shall disclose to a real estate affiliate thereof, directly or indirectly, nor shall any real estate affiliate directly or indirectly disclose to an affiliated bank, any nonpublic information (including an evaluation of the creditworthiness of a customer) except in connection with a lawful extension of credit by the bank affiliate to such a real estate affiliate."

"(vii) INTERLOCKS -- No officer, director or employee of a real estate affiliate shall serve at the same time as an officer, director, or employee of any bank affiliate."

"(viii) FUNDING OBLIGORS -- No affiliate of a bank holding company shall, directly or indirectly, make any extension of credit, arrange for any extension of credit, or sell or purchase real property where such action has the effect of enabling a debtor of a real estate affiliate thereof to repay an obligation to such real estate affiliate."

"(ix) IDENTIFICATION -- No bank affiliate shall have a name or graphic identification in common with a real estate affiliate, or indicate in any advertising or other public media the fact of affiliation with any real estate affiliate or share public or private premises with any of its real estate affiliates; name and graphic identification in common with its bank holding company is permitted for a real estate affiliate if there is no common name or graphic identification between the bank holding company and any bank affiliate."

"(x) DEFINITIONS -- For the purpose of this subsection (B), a bank affiliate shall be deemed to be affiliated with any company, account or other entity with respect to which the bank affiliate or any affiliate thereof exercises investment discretion, and the term "real estate affiliate" shall be deemed to include any joint venture, partnership or other company engaged in real estate activities in which such real estate affiliate has a direct or indirect interest of any kind."

"(D)APPLICATION REQUIREMENTS --

"(i) A bank holding company shall not acquire shares of a real estate affiliate pursuant to this paragraph without the Board's prior approval.

"(ii) The Board shall not approve a notification or application under this paragraph unless the Board is satisfied that the bank holding company and a real estate affiliate possess the managerial and financial resources to supervise and conduct the activities described in subparagraph (A) of this paragraph without unduly increasing risk for the bank holding company and its bank and thrift institution affiliates. Maintaining the safety and soundness of the bank holding company shall be a principal consideration. In making its determination, the Board shall take into account the experience of management and its record of successfully managing the bank holding company and of activities that are the same as or similar to those authorized for real estate affiliates under subparagraph (A) of this paragraph. In addition, in determining whether to approve an application under this paragraph, the Board shall consider whether the performance of the activity or activities by the real estate affiliate described in the notice or application can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices; provided that any application submitted within one year of the date of the enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988 by a bank holding company which on the date of such enactment was carrying on activities enumerated in subsection 4(c)(16) and seeks to conduct such activities in a real estate affiliate need qualify under the requirements of this clause only with respect to activities in which it was not engaged on the date of such enactment.

"(E) REAL ESTATE ACTIVITIES OF BANK AFFILIATES -- A bank affiliate may engage in such real estate activities as are otherwise authorized by applicable state or federal law but only with respect to:

"(i) An interest in real property that is primarily used by the bank affiliate or its affiliates as offices or related facilities for the conduct of its business;

"(ii) An interest in real property that is acquired in satisfaction of debts previously contracted in good faith or at sales under judgments, decrees or mortgages held by the bank, provided that the property is not held longer than permitted by any applicable law or regulation;

"(iii) An interest in real property held by the bank affiliate in a fiduciary capacity;

"(iv) A right to receive a portion of a borrower's gross or net income from the operation of real property or refinancing of real property in lieu of all or a portion of interest on a loan to a borrower secured by such real property;

"(v) An interest in real property that is primarily in the nature of a charitable contribution to community development;

"(vi) An interest in real property which is leased to a third party where the lease serves as the functional equivalent of an extension of credit to the lessee of the real property, the real property to be leased is acquired specifically for the leasing transaction under consideration or was acquired specifically for an earlier leasing transaction, and at the inception of the initial lease the effect of the transaction and, with respect to governmental entities only, reasonably anticipated future transactions, will be to yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease;

(vii) An interest in securities issued by an investment company or a real estate investment trust which is not affiliated with the bank affiliate, provided such securities are held for investment and not with a view to resale or distribution, to the extent otherwise permitted by this Act;

"(viii) A direct or indirect interest in promissory notes secured by liens on real property including participation interests in such notes and any other securities representing interests in or which are secured by such notes, provided such interests are held for investment and not with a view to resale or distribution, to the extent otherwise permitted by this Act; and

"(ix) Any other interest in real property lawfully acquired by the bank affiliate prior to the date of enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988."

"(F) REAL ESTATE ACTIVITIES OF NONBANK AFFILIATES -- A nonbank affiliate may engage in such real estate activities as are otherwise authorized by applicable state or federal law but only with respect to those activities described in subparagraphs (E)(i) through (ix) of this subsection.

SECTION 103. AMENDMENTS TO THE FEDERAL RESERVE ACT

(a) Section 5(c) of the Federal Reserve Act (12 U.S.C. 335) is amended by striking the words "the purchasing, selling, underwriting, and holding of investment securities and stock" and inserting in lieu thereof the words "securities activities".

(b) The Federal Reserve Act is amended by inserting therein the following new section:

"SECTION _____.

"Discriminatory Credit Treatment"

"Member banks shall be subject to the same restrictions as to discriminatory credit treatment as are applicable to bank holding companies and their affiliates under subparagraph 1843(c)(15)(M) of this title."

SECTION 104. AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by inserting at the end thereof the following new subsection:

"Restrictions Applicable to Insured Banks Which Are Affiliates of Bank Holding Companies"

(m) No insured bank which is an affiliate of a bank holding company as defined in the Bank Holding Company Act shall engage in, nor shall the Corporation authorize such an insured bank to engage in, any activities or transactions that may not be engaged in by a bank affiliate under section 1843 of this title."

SECTION 105. AMENDMENTS TO THE NATIONAL HOUSING ACT

Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by inserting at the end thereof the following new subsection:

"Restrictions Applicable to Insured Institutions Which Are Affiliates of Bank Holding Companies"

(u) No insured institution which is an affiliate of a bank holding company as defined in the Bank Holding Company Act shall engage in, nor shall the Board authorize such an insured institution to engage in, any activities or transactions that may not be engaged in by a bank affiliate under section 1843 of this title."

SECTION 106. RULINGS ON SECURITIES ACTIVITIES

The Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board may not issue any rule, regulation, order, interpretation or opinion formally or informally to the effect that particular activities or transactions do not constitute securities activities as defined in Section 2 of the Bank Holding Company Act (12 U.S.C. 1841). The Securities and Exchange Commission shall have the power pursuant to section 19(d) of the Securities Act of 1933 (15 U.S.C. 77s(d)), as added by this Act, to issue rules, regulations, orders, interpretations and opinions with respect to securities activities as defined in such act.

SECTION 107. TRANSITION PROCEDURES

The Chairmen of the Securities and Exchange Commission, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board and the Comptroller of the Currency shall serve as a coordinating committee to develop and prescribe procedures for the restructurings contemplated by this title and titles II and III, particularly the transfer of existing securities activities into securities affiliates to be established pursuant to subsection 4(c)(15) of the Bank Holding Company Act (12 U.S.C. 1843(c)(15)) and subject to the oversight and regulation as provided by amendments to the Securities Act of 1933 (15 U.S.C. 77s et seq.) and the Securities Exchange Act of 1934 (15 U.S.C. 78c et seq.) as added by title III of this Act. The Chairman of the Securities and Exchange Commission shall serve as chairman of the coordinating committee. An activity or affiliation that becomes unlawful as a result of the enactment of this title and titles II and III may continue for a period of one year after enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988.

TITLE II -- INTERNATIONAL PROVISIONS -- SECURITIES ACTIVITIES ABROAD OF U.S. BANKING ORGANIZATIONS

SECTION 201. CONDUCT OF SECURITIES ACTIVITIES ABROAD BY U.S. BANKING ORGANIZATIONS THROUGH SECURITIES AFFILIATES

(a) Paragraph 10 of section 25 of the Federal Reserve Act (12 U.S.C. 604a) is amended by adding at the end thereof the following sentence:

> "Any securities activities as defined in section 1841 of this title shall be conducted in a securities affiliate described in section 2(n) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) and transactions between such securities affiliate and other affiliates shall be subject to the provisions of subparagraphs (D) through (P) of section 1843(c)(15)."

(b) Paragraph 6 of section 25(a) of the Federal Reserve Act (12 U.S.C. 615) is amended by striking the words "to purchase and sell with or without its endorsement or guaranty, securities, including the obligations of the United States or any State thereof but not including shares of stock in any corporation except as herein provided" in the first sentence thereof and adding after the first sentence thereof the following sentence:

> "No securities activities shall be conducted abroad and transactions between a securities affiliate described in section 2(n) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) of a corporation organized under section 25(a) and other affiliates shall be subject to the provisions of subparagraphs (D) through (P) of section 1843(c)(15)."

(c) Section 4(c)(13) of the Banking Holding Company Act of 1956 (12 U.S.C. 1843(c)(13)) is amended by inserting the words "other than one engaged in securities activities, which are to be engaged in, if at all, only in securities affiliates authorized by subsection 4(c)(15)" after the word "company".

SECTION 202. TRANSITION RULE

An activity or affiliation that becomes unlawful as a result of the enactment of this title may continue for a period of one year after enactment of the Comprehensive Bank Insulation and Fair Competition Act of 1988; provided, the appropriate Federal regulatory agency may extend the period for up to one additional year if required for compliance with regulations of a foreign regulatory agency.

TITLE III -- FUNCTIONAL REGULATION OF SECURITIES AFFILIATES BY THE SECURITIES AND EXCHANGE COMMISSION

SECTION 301. AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934 PROVIDING FOR SECURITIES AFFILIATE REGULATION BY THE SECURITIES AND EXCHANGE COMMISSION AS BROKER-DEALER

(a) Section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) is amended by inserting, prior to the word "but," the following clause: ", not excluding a securities affiliate as defined in Section 2(n) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(n))."

(b) Section 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(5)) is amended by inserting, prior to the words "but does not include a bank," the following clause: ", not excluding a securities affiliate as defined in Section

2(n) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(n))."

SECTION 302. SECURITIES AFFILIATES SUBJECT TO REGULATION BY COMMODITY FUTURES TRADING COMMISSION

Section 2(a) of the Commodity Exchange Act (7 U.S.C. 2) is amended by striking the period at the end of the second sentence and inserting in its place a comma followed by the clause: "not excluding a securities affiliate, as defined in Section 2(n) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(n))."

SECTION 303. ACCOUNTING PRINCIPLES, REPORTING AND REGISTRATION REQUIREMENTS FOR SECURITIES AFFILIATES

Section 17(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(a)) is amended by adding at the end thereof the following paragraph:

> "(4) In regulating securities affiliates, as defined in Section 2(n) of the Bank Holding Company Act of 1956, the Commission shall expressly require such securities affiliates to conform to all accounting principles and reporting required for brokers and dealers under the Securities Exchange Act of 1934 with respect to financial statements or otherwise, including without limitation marking-to-market requirements.

(b) A securities affiliate, as defined in Section 2(n) of the Bank Holding Company Act, shall, with respect to registration, reporting and other requirements applicable to any activities in which it is engaged, be treated as if it were not owned by or affiliated with a bank holding company.

SECTION 304. AMENDMENTS TO SECURITIES ACT OF 1933 TO PROVIDE SPECIAL POWERS OF SECURITIES AND EXCHANGE COMMISSION WITH RESPECT TO SECURITIES AFFILIATES

(a) Section 19 of the Securities Act of 1933 (15 U.S.C. 77s) is amended by adding at the end thereof the following new subsections:

> "(d) In addition to its authority to regulate securities affiliates, as defined in Section 2(n) of the Bank Holding Company Act of 1956, as brokers or dealers, the Commission is authorized --

"(1) to enforce the restrictions applicable to securities affiliates and their dealings with others under Section 4(c)(15) of the Bank Holding Company Act as added by the Comprehensive Bank Insulation and Fair Competition Act of 1988;

"(2) to enforce, alone or with the Federal Reserve Board, the provisions of Section 23A and Section 23B of the Federal Reserve Act as applicable to transactions involving securities affiliates;

"(3) to assume responsibility for the oversight and regulation of securities activities within a securities affiliate, including those which were formerly overseen and regulated by the Comptroller of the Currency, Federal Deposit Insurance Commission or the Federal Reserve Board, except as herein provided; and to develop regulations and legislative recommendations with respect to such responsibilities; the Commission shall cooperate with the Federal Reserve Board with respect to its overall responsibilities for the bank holding company;

"(4) notwithstanding any other provision of law, to determine definitively upon request of any concerned party (i) whether particular activities constitute securities activities as defined in paragraph Seventh of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24) and in Section 2 of the Bank Holding Company Act (12 U.S.C. 1841); provided that there shall be a presumption that an activity is a securities activity if one or more of the following factors is or may be present: a bank or securities affiliate is involved in any manner in the purchase, sale or transfer of a security or a right or obligation to purchase or sell a security; the activities are susceptible to speculation, manipulation, or control; or the activities expose the parties involved to risk due to sudden fluctuations in value; and (ii) whether the conduct of particular securities activities is within the existing authority of a securities affiliate pursuant to section 4(c)(15)(A) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)); and

"(5) to exercise existing enforcement authority and to issue new rules to provide for separation of securities affiliates from affiliated banks and bank holding companies and to minimize the enlargement of risk borne by the federal government and the potential for unfair competition from securities activities of securities affiliates.

"(6) to issue rules, regulations, orders, opinions and directives with respect to its authority and its oversight, supervisory and regulatory responsibilities relating to securities affiliates of bank holding companies and its other responsibilities relating to securities activities as defined in the Bank Holding Company Act (12 U.S.C. 1841) and Paragraph Seventh of Section 16 of the National Bank Act (12 U.S.C. 24)."

"(e) The Commission shall establish procedures for the filing of notices, requests for actions and complaints by parties injured or threatened with injury (including customers, competitors and trade associations) by violations or nonenforcement of (i) the restrictions applicable to securities affiliates contained in subsection 4(c)(15) of the Bank Holding Company Act and (ii) other restrictions on the conduct of securities activities by securities affiliates as defined in Section 2 of the Bank Holding Company Act (12 U.S.C. 1841) and others as added by the Comprehensive Bank Insulation and Fair Competition Act of 1988."

(b) Nothing in this Act shall reduce the authority of the Commodity Futures Trading Commission, or the authority of the Federal Reserve Bank of New York with respect to regulation of transactions in obligations of the United States.

TITLE IV -- FINANCIAL INSTITUTIONS STRUCTURAL REVIEW COMMISSION

SECTION 401. ESTABLISHMENT AND COMPOSITION OF COMMISSION

(a) There is hereby established a Financial Institutions Structural Review Commission to be known as the Commission (hereinafter in this title referred to as the "Commission").

(b) (1) The Commission shall consist of the following voting members:

(A) Twenty Members of Congress consisting of the senior three majority and two minority members from each of the House Committees on Banking, Finance and Urban Affairs and on Energy and Commerce (but including the chairman and ranking minority member of each Committee and of the Subcommittee on Telecommunications and Finance); and of the senior six majority and four minority members of the Senate Committee on Banking, Housing, and Urban Affairs (but including the chairman and ranking minority member of the Committee and of the Securities Subcommittee).

(B) The Chairman of the Securities and Exchange Commission.

(C) The Chairmen of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board.

(D) The Chairmen of the Commodity Futures Trading Commission, the National Association of Securities Dealers and the New York Stock Exchange and the President of the National Association of Insurance Commissioners.

(2) The Commission shall be chaired by the three Chairmen of the Congressional committees. The Commission shall adopt such rules as may be appropriate to establish its procedures and to govern its operations, organization and personnel. Eleven Congressional members of the Commission shall constitute a quorum. Any vacancy in the Congressional representation on the Commission shall not affect its powers, but shall be filled in the order of seniority from the majority and minority of each Committee.

(3) In addition, there shall be twenty non-voting advisory members appointed by the chairmen who shall be prominent and acknowledged experts with respect to financial institutions or with respect to the capital (including credit) requirements of the private or public sectors of the United States and world economies; and shall include, to the extent feasible, members who broadly represent

(A) users and suppliers of capital, such as large and small businesses, agriculture, housing, energy, state and local governments, labor, consumers, institutional and individual investors and depositors and other suppliers of capital;

(B) financial concerns, including commercial and investment banks, stock brokers, insurance agents, insurance companies, thrifts and diversified financial companies;

(C) state bank and thrift and credit union supervisors and securities administrators; and

(D) academic interests.

SECTION 402. FUNCTIONS OF THE COMMISSION

(a) (1) The Commission shall undertake a comprehensive review of the future of financial institutions in the United States and the world. The Commission shall make a report with recommendations to Congress within two years of commencement of operations. The Commission shall consider what changes in the laws will serve the national interest and make recommendations consistent with its findings and the national interest and thereafter will continue to observe the financial markets until further duties are prescribed by Congress. The Commission shall examine, evaluate and consider

(A) the history and functioning of the Glass-Steagall Act, the Bank Holding Company Act and the separation of banking and commerce and of commercial banking and investment banking;

(B) the adequacy of regulation of federally-insured depository institutions and non-depository financial institutions domestically and worldwide and whether the existing prohibitions against the combining of commercial and banking companies, including those between securities firms and banking companies with commercial powers, should be strengthened, eliminated or revised;

(C) how the delivery of needed financial services in the United States and the world can be best achieved, with a view to preserving and enhancing fair competition, diversity of choices for consumers, other citizens and businesses and the functioning of capital markets within the United States and worldwide;

(D) the need for additional regulation and coordination of regulation of financial institutions and equity, credit, exchange, futures and options and other financial markets both in the United States and worldwide;

(E) access to and operations of the payments systems;

(F) the advantages of federally-insured depository institutions (including insured banks within bank holding companies and insured institutions) and the risks to and responsibilities of the federal government associated with their support and whether and how their functions should be enlarged, decreased or otherwise changed;

(G) the advantages and disadvantages of extending or reducing the roles of federally-supported financial institutions in underwriting, distributing, placing and dealing in corporate debt and equity securities and in state and local government securities;

(H) how to ensure the continued existence of independent, non-federally-insured or supported suppliers of financial services, such as securities firms, and how the availability of credit to them from federally-supported financial institutions can be assured, particularly in times of emergency;

(I) whether in a world of technologically-increased connectivity, barriers or disconnects are desirable to reduce the spread of unnecessary damage at times of financial crisis and, if so, what they might be;

(J) the present operations of American bank holding companies and their affiliates outside of the United States, including the sources of their funding;

(K) the development of a system based on self-operative prohibitions for the regulation of proper conduct by federally-advantaged financial institutions, recognizing the inherent limitations of regulatory oversight;

(L) the adequacy and sources of capital for depository and non-depository financial institutions;

(M) how to preserve and enhance the safety and soundness of American federally-insured banks, thrifts and bank holding companies;

(N) the functioning and competitiveness of the national and international securities, commodities and exchange markets and changes that are being undertaken in other countries and their impact on American markets and the participation by American financial institutions abroad;

(O) the need for liquidity of the several financial markets and their participants and the advantages and disadvantages and risks associated with direct liquidity access to the Federal Reserve by American-based non-depository as well as depository financial institutions;

(P) the adequacy for investor protection of the laws and regulatory structures governing the financial markets in the United States and worldwide with respect to securities and securities-like products, commodities, futures, options, swaps and other financial instruments;

(Q) the effectiveness in reducing risk to the federal taxpayer and unfair bank advantage of the so-called "firewall provisions" and the structure incorporated into the Bank Holding Company Act by the Comprehensive Bank Insulation and Fair Competition Act of 1988 for the exercise of certain non-banking securities and related powers by bank holding companies;

(R) the advantages and disadvantages of extending or reducing the roles of federally-supported financial institutions to the underwriting, managing and distribution of commonly-owned funds, pensions and trusts; and

(S) such other matters as the Commission shall deem desirable to ensure continued strength of American financial institutions, better financial services and products for American consumers and businesses, continued American leadership in world financial markets, continuation of safety and soundness in the American banking system, continuation of free, open and competitive capital markets in the United States, continuation of independent providers of financial services in fair competition with government-supported financial institutions and the generation of the capital needed for the American and world economies.

(2) In carrying out the evaluations required by paragraph (1), the Commission shall consider the role and impact of modern information technologies and policies; and the channels for capital flows between the domestic and international markets and how these flows affect the supply of credit and capital available to domestic, including governmental, borrowers and what should be done, if anything, to enhance or retard these credit flows.

(3) In carrying out the evaluations required by paragraph (1), the Commission shall make use of existing government and private data bases; and studies and materials previously developed by public and private entities and individuals, where they exist, in order to avoid duplication of effort. In addition, the need is recognized for extensive development of new studies and materials by and for the Commission.

(4) The Commission shall maintain a close working relationship with its non-voting members and shall consult extensively with committees and staffs of Congress with relevant jurisdiction and members of the Cabinet and officials of such other agencies or organizations, both foreign and domestic, and such other persons whose role or knowledge will assist the Commission in making its evaluations and developing its recommendations.

(5) The Commission shall provide opportunities for its non-voting members and the government officials described in paragraph (4) to comment on its findings, conclusions and recommendations during their development and prior to the submission of its report to Congress.

(b) The Commission shall hold its first meeting not later than three months after the date of enactment of this Act, and, not later than 24 months after the initial meeting of the Commission, the Commission shall submit to the Congress a report on the results of its evaluations under subsection (a). Such report shall include the Commission's findings and conclusions with respect to each matter required to be evaluated or considered under such subsection or which was in fact considered or evaluated by the Commission; shall take into account the views of the non-voting members and the officials referred to in subsection (a)(4); and shall also include recommendations for legislative or administrative action to implement necessary improvements in federal or state laws or regulations with respect to the functioning and regulation of financial institutions and their interrelationships in meeting capital and credit needs of the American financial markets and, to the extent considered to be relevant, the world financial markets; and the data and analyses used in developing the Commission's findings, conclusions and recommendations and an identification of any data or analyses which the Commission desired but was unable to obtain.

(c) Following receipt by Congress of the Commission's report and recommendations under subsection (b), those members of the Commission who are Members of Congress shall cease to be members of the Commission and the Commission shall continue in existence to provide coordinated observance of the operations of the financial markets.

(d) The remaining members of the Commission shall continue in office and the Commission shall have such additional duties as federal law shall thereafter prescribe. The interim chairmen of the Commission shall be the chairmen of the Federal Reserve Board and the Securities and Exchange Commission.

SECTION 403. COMPENSATION OF COMMISSION MEMBERS

The members of the Commission shall serve without any compensation. All members of the Commission shall be reimbursed for travel, subsistence and other necessary expenses incurred by them in the performance of the duties vested in the Commission.

SECTION 404. COMMISSION STAFF

(a) The Commission shall have power to appoint and fix the compensation of such personnel as it deems advisable to assist in the performance of its duties, without regard to the civil service laws and without regard to the provisions of title 5 of the United States Code (or any other law) relating to the number, classification, or compensation of employees. The Commission may also procure, without regard to the civil service laws and such title 5, temporary and intermittent services to the same extent as is authorized by law for agencies in the executive branch but at rates not to exceed the daily equivalent of the maximum annual rate of basic pay in effect for grade GS-18 of the General Schedule.

(b) Service of an individual as a member of the Commission or employment of an individual by the Commission as an attorney or expert in any business or professional field, on a part-time or full-time basis, with or without compensation, shall not be considered as service or employment bringing such individual within the provisions of any federal law relating to conflicts of interest or otherwise imposing restrictions, requirements, or penalties in relation to the employment of persons, the performance of services, or the payment or receipt of compensation in connection with claims, proceedings or matters involving the United States.

SECTION 405. POWERS OF THE COMMISSION

(a) The Commission or any member authorized by the Commission may, for the purpose of carrying out this title, hold such hearings and sit and act at such times and places, take such testimony, have such printing and binding done, enter into such contracts and other arrangements (with or without consideration or bond, and without regard to section 3709 of the Revised Statutes (41 U.S.C. 5), make such expenditures, and take such other actions as the Commission or such member may deem advisable. The Commission may call upon members and staff of the House Committee on Banking, Finance and Urban Affairs, the House Committee on Energy and Commerce and the Senate Committee on Banking, Housing, and Urban Affairs for assistance in conducting hearings, developing information or otherwise doing its work. Any member of the Commission may administer oaths or affirmations to witnesses appearing before the Commission or before such member.

(b) The Commission is authorized to secure directly from any officer, department, agency, board, commission, establishment or instrumentality of the Government such information, suggestions, estimates, and statistics as the Commission may require for the purpose of this title; and each such officer, department, agency, board, commission, establishment or instrumentality is authorized and directed to furnish such information, suggestions, estimates, and statistics directly to the Commission, upon request made by any of the chairmen.

(c) Upon request of the Commission, the head of any Federal agency is authorized to make any of the facilities and services of such agency available to the Commission or to detail any of the personnel of such agency to the Commission, on a reimbursement basis to assist the Commission in carrying out its duties under this title.

(d) The Commission may use the United States mails in the same manner and under the same conditions as other departments and agencies of the United States.

(e) No officer or agency of the United States shall have the authority to impose any restriction upon the Commission with respect to the scope, direction, or conduct of its activities, or to require that the Commission submit any report, recommendation, or other matter to any such officer or agency for approval, comment, or review before submitting such report, recommendation, or other matter to the Congress.

SECTION 406. EXPENSES OF THE COMMISSION

There are hereby authorized to be appropriated such sums as may be necessary to carry out this title.

TITLE V -- ENFORCEMENT

SECTION 501. PRIVATE RIGHT OF ACTION

(a) Any person (including a customer, competitor or trade association) who suffers injury or the threat thereof may commence a civil action on his own behalf --

(1) against (A) any person who is alleged to be in violation of (i) any requirement of this Act or (ii) an order issued by any regulatory agency with respect to any requirement in this Act or (B) any action or inaction by any federal regulator that has the effect of authorizing or

allowing securities, real estate or insurance activities not authorized under this Act to be undertaken by any affiliate of a bank holding company, national bank or member bank.

(2) For purposes of Section 501(a)(1), any person who suffers injury or the threat thereof, including any customer, competitor or trade association, by any rule or regulation, action or inaction, formal or otherwise, of any federal regulator, authorizing or allowing securities, real estate or insurance activities not authorized under this Act to be undertaken by any bank affiliate of a bank holding company, national bank or member bank, including individual opinions of staff or counsel, written or oral, may challenge such rule or regulation, action or inaction, formal or otherwise, of such regulator or its staff or counsel, or the authority of such regulator or its office to take or not take any such action, in any federal district court as if it were final agency action.

(3) The district courts or any other court of competent jurisdiction shall have jurisdiction, without regard to the amount in controversy or the citizenship of the parties, to enforce the requirements of this Act, or such an order, or to order the appropriate regulatory agency to perform such act or duty, and to apply any civil penalties as may be appropriate under Section 503 of this title.

(b) The court, in issuing any final order in any action brought by a plaintiff against a regulator pursuant to this section, may award costs of litigation (including reasonable attorneys and expert witness fees) to any successful plaintiff, whenever the court determines such award is appropriate. The court may, if a temporary restraining order or preliminary injunction is sought, require the filing of a bond or equivalent security in accordance with the Federal Rules of Civil Procedure.

SECTION 502. CRIMINAL PENALTIES

(a) Any national bank, member bank, bank holding company or affiliate thereof that knowingly and willfully violates or knowingly and willfully participates in a violation of any provision of this Act or any rule, regulation or order issued by an appropriate federal agency pursuant thereto, shall upon conviction be fined not more than the greater of $250,000 or an amount equal to 1/100 of one per centum of the minimum required capital of the relevant national bank, member bank, bank holding company or affiliate thereof for each day during which a violation exists, except that in no case shall any such amount for any violation or related series of violations exceed one per centum of the minimum required capital of the relevant national bank, member bank or bank holding company.

(b) Any officer, director, employee or agent of any national bank, member bank, bank holding company or affiliate thereof, and any other natural person who knowingly and willfully participates in a violation of any provision of this Act or any rule, regulation, or order issued pursuant thereto, shall upon conviction be imprisoned not more than five years or fined not more than the greater of $250,000 or double the individual's compensation at the time the violation occurred, or both.

(c) Every officer, director, employee and agent of a national bank, member bank, bank holding company or affiliate thereof also shall be subject to to the same penalties for false entries in any book, report, or statement of such national bank, member bank, bank holding company or affiliate thereof as are applicable to officers, directors, employees and agents of member banks for false entries in any books, reports or statements of national banks, bank holding companies and affiliates thereof under section 1005 of Title 18.

SECTION 503. CIVIL MONETARY PENALTIES

(a) Any national bank, member bank, bank holding company and affiliates thereof which participates in a violation of this Act, or regulations or any order issued by an appropriate Federal regulatory agency pursuant thereto, shall forfeit and pay a civil money penalty of not more than the greater of $250,000 or an amount equal to 1/100 of one per centum of the minimum required capital of the relevant national bank, member bank, holding company or affiliate thereof for each day during which such violation continues, except that in no case shall any such amount for any violation or related series of violations exceed one per centum of the minimum required capital of the relevant national bank, member bank or bank holding company.

(b) Any officer, director, employee or agent of any national bank, member bank, bank holding company or affiliate thereof affiliate and any other person who participates in a violation of any provision of this Act or any rule, regulation or order issued by an appropriate Federal regulatory agency pursuant thereto shall forfeit and pay a civil money penalty of not more than the greater of $250,000 or double the individual's annual compensation at the time the violation occurred.

(c) The appropriate Federal regulatory agency shall have authority to assess such a civil money penalty, after giving notice and an opportunity for a hearing to the national bank, member bank, bank holding company and affiliates thereof, or an officer, director, employee, agent or other natural person for any violation of this Act.

SECTION 504. REGULATORY ENFORCEMENT

In addition to the powers listed above, the appropriate Federal regulatory agency or agencies shall have the authority, with respect to any violation of this Act by a national bank, member bank, bank holding company or affiliate thereof to --

(a) require divestiture by the holding company of one or more securities affiliates, bank affiliates or other affiliates, as the agency may deem appropriate, within a period not to exceed one year from the date of such order,

(b) impose additional capital requirements,

(c) issue an order to cease and desist from such violation or practice, or

(d) bring an action in the United States court of appeals for the District of Columbia circuit or any other court of competent jurisdiction to enforce an order issued under this Act.

SECTION 505. APPROPRIATE FEDERAL REGULATORY AGENCY

For purposes of this Act, the term "appropriate federal regulatory agency" shall mean the Comptroller of the Currency in the case of national banks or District banks, the Board of Governors of the Federal Reserve System in the case of (i) bank holding companies and any subsidiaries or affiliates thereof (other than securities affiliates), and (ii) member banks (other than national banks), the Board of Directors of the Federal Deposit Insurance Corporation in the case of insured banks that are not members of the Federal Reserve System (except a District bank), the Federal Home Loan Bank Board in the case of insured institutions, and the Securities and Exchange Commission in the case of (i) securities affiliates and (ii) any affiliates thereof, to the extent necessary to perform its regulatory functions under Title III of this Act.

TITLE VI -- EFFECTIVE DATE

SECTION 601. EFFECTIVE DATE

Except as specifically set forth herein, and excepting the provisions of Title V, the effective date of the Act shall be

the date of introduction thereof. The provisions of Title V shall be effective on the date of enactment of this Act.

2256S/88

STATEMENT OF

SECURITIES INDUSTRY ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

FEBRUARY 2, 1988

JOHN W. BACHMANN,
SIA CHAIRMAN AND
MANAGING PRINCIPAL, EDWARD D. JONES & CO.

WITH HIM

EDWARD I. O'BRIEN,
SIA PRESIDENT

AND

ROBERT A. GERARD
CHAIRMAN, SIA MUNICIPAL FINANCE COMMITTEE AND
MANAGING DIRECTOR, MORGAN, STANLEY & CO. INCORPORATED

Mr. Chairman and members of the Subcommittee:

My name is John W. Bachmann, Chairman of the Securities Industry Association and managing principal of Edward D. Jones & Co., headquartered in St. Louis. Edward D. Jones has over 1400 offices throughout the country with more than 3,000 employees. Also with me is Edward I. O'Brien, President of the Securities Industry Association and Robert A. Gerard, a managing director of Morgan, Stanley & Co. Incorporated in charge of Municipal Finance. Mr. Gerard also serves as the Chairman of SIA's Municipal Finance Committee.

SIA is an association of more than 550 securities firms located throughout the United States and Canada. We are grateful for the opportunity to appear before this Subcommittee to discuss how to proceed with the restructuring of our nation's financial system. There are many, many difficult issues involved. SIA has maintained throughout the years that the principles involved in the separation of banking and commerce reflected in the Bank Holding Company Act and the Glass-Steagall Act made a good deal of sense. Banks, as the government-backed suppliers of credit to the economy have a definite and distinct role to play, and everyone else, including securities firms, insurance firms, retailers and manufacturers ultimately depend on a safe, sound and secure banking system as the heart of our financial system.

Financial firms in the private sector have offered alternatives to services supplied by the government-supported banks and sometimes these alternatives have been more attractive to consumers and businesses. For example, money market mutual funds enabled consumers in the recent period of high inflation to receive a return on their savings well in excess of the rate of interest on bank deposits. Securities firms' distribution of commercial paper has enabled companies to raise funds at costs well below the 250 to 300 basis point spread over cost of funds that banks like to demand. Consumers were shown a way to escape carrying the burden of inflation unfairly and businesses with lower financing costs could deliver their products and services to their customers for lower prices. We are proud that our separate securities industry is able to produce such benefits for consumers and business.

Congress determined in 1933, after extensive hearings, that it would be wise to separate commercial banks from most of the risks of the securities markets. With all of the problems that our largest banks have with their loan portfolios it certainly was provident that banks were not in the stock market on

October 19th. Even the Comptroller of the Currency's first reaction was relief that banks were not in the markets. Public confidence in banks was not shaken by the markets' sharp fall.

For reasons that are obvious, the Glass-Steagall Act is the part of the wall between banking and commerce that has most concerned our industry. It is our position that the Glass-Steagall Act should not be looked at in isolation. If it is determined that world competition may necessitate changes in how we organize our financial industries, then we should look at the stability and public policy framework more broadly than simply at revisions to the Glass-Steagall Act. For example, the securities business is more and more a capital-intensive business. Where will the capital come from to provide the needed buffers when there are fall-offs such as the one that occurred on October 19th. Where is the capital for our business coming from now? It has been coming from public stock issues, but also from alliances with strong firms in other lines of commerce--General Electric, Sears, American Express, Primerica, Equitable, Travelers and Prudential, just to name a few.

The fact is that many banks, including some of our best-known, are experiencing severe capital deficiencies. If unallocated loan loss reserves were not counted as primary capital for banks or banks had to mark their inventories to market as securities firms do, many of the banks which have been expressing the most interest in getting further into the securities business would appear to be quite capital-short for their regular banking business.

These issues are complex, difficult and involve long-held beliefs and positions. The question is how to proceed to deal with these issues in a rational manner.

Banks clearly want the full complement of securities powers, including the power to underwrite, distribute and recommend securities. They have stated openly that they really want insurance and real estate powers too, but they know that taking on these three industries at once is too much. So the securities industry has been singled out as the first target with the expectation that "enlightened" self-interest of at least the other two industries will keep them neutral as banks mount their invasion of the securities business.

There has been a great deal of talk about securities firms and others getting into the banking business. Closing off consumer banks last year was aimed at securities firms in large measure. However, non-bank bank assets are a miniscule percentage of all bank assets.

Banks are far more into the securities business than securities firms are in the banking business. Exceptions to Glass-Steagall and regulatory erosion over the years have given banks more and more securities powers. And over the years banks have consistently provided unfair competition in the securities business for securities firms. We have already mentioned the favorable accounting rules that prop up capital and do not require bank inventory to be marked to market. For years bank tax advantages in the municipal securities business were enormous--the benefits of which, by the way, were not passed on to state and local governments nor to bondholders in any discernible way. Some of those tax advantages still remain.

We need not dwell on the relationship power that arises out a bank's role as the government-advantaged principal supplier of credit in the economy . If that bank can also sell insurance, such as credit insurance, it is far more likely to sell such insurance to a credit customer. Is there coercion? Probably not, but a customer instinctively reacts; why take a chance of creating offense? Buy the insurance or brokerage services from the bank and don't worry about it.

There are other examples. The supplier of credit also gains an advantage through the unfair combining of credit with its securities dealings. The laws against tying by banks in this area are totally ineffective. Studies show dramatically how a government-supported bank uses its ability to provide a letter or line of credit as its entree to a underwriting role. Does it coerce? Does it force? Of course not. Subtlety among sophisticated people is all that is needed. Is this unfair? It is indeed.

Banks have exclusive access to almost all parts of the payments system. For example, securities firms have to clear their government securities transactions through clearing banks which are also in the government securities business. Securities firms pay a fee; banks pocket the fee from the securities firms and can either make a fee on their own transactions or not charge themselves at all: either way, the bank makes money from the securities firm and has a cost advantage on its own clearances.

Banks obtain funds more cheaply. An insured account pays a lower rate of interest. Yet even supposedly uninsured depositors take great comfort in knowing that a bank has federally-insured accounts, that it may be "too big to fail." Congress has recognized the reality of the situation in Title 12 of the U.S. Code: we now have "insured banks" and "insured institutions." So money is more readily and more cheaply available than it otherwise would be because of government support for the bank.

Adding to that support is the Federal Reserve. The Federal Reserve supplies liquidity and credit support to banks directly. When Continental Illinois was faltering, billions of dollars flowed in from the Federal Reserve to keep it afloat; the peak reached $8 billion outstanding, as we understand it, but over the period of risk many billions more were funnelled through. Unsecured creditors of the holding company as well as of the bank were able to beat a safe retreat.

At times of liquidity crises for the economy, banks turn to the Federal Reserve; securities firms and others must turn to banks. The Federal Reserve makes mostly macroeconomic judgments to support the banking system and, in individual cases, favorable credit judgments to keep weaker banks up. Securities firms and others are subjected to liquidity/credit judgments by banks which tend to protect the bank; that is, in case of doubt, liquidity is less likely to be supplied by the bank to the would-be borrower. During the October 19th experience the Fed was being expansive, but banks reportedly had to be urged by the Fed to keep liquidity flowing to their customers in the securities business. In our economic system, banks are supposed to sit as independent, objective suppliers of credit. If a bank is competing with a customer applying to it for credit in a crisis, is it less likely to make the credit available? Would objectivity be compromised? Who knows? Could it be? Yes.

What will further bank entry into the securities business mean for the federal safety net? If banks become deeply involved in the capital markets, much greater supervision will be needed to ensure that insured deposits are not placed at risk by securities operations and that banks cannot compete unfairly. Of necessity, that means more, not less, regulation; it certainly is not deregulation. Will the capital markets as as a result become less free and less dynamic? There are many studies and suggestions being formulated now in the wake of October 19 and we will all know more later.

Under the present banking structure bank regulators, including the Federal Reserve, and the U.S. Treasury--all supported by the U.S. taxpayer--stand foursquare directly behind our banks. In a sense, they stand behind other financial institutions and the economy, but only indirectly, when the integrity of the banking system itself is threatened. How can one prevent the federal safety net from being stretched further to pick up securities activities of a bank? Why should the taxpayer assume this kind of risk at all? For example, if Glass-Steagall were repealed and all securities operations were inside a bank, the federal safety net would be riding the ups and downs of the stock market. That is not a good idea.

The securities industry thus far has shown it can operate without the direct support of the federal safety net. It therefore is an unnecessary risk for the taxpayer and an unfair disadvantage for the securities industry for the federal safety net to be supporting existing bank securities activities, let alone any new ones. To the extent that banks are in the government securities and municipal bond business now, the federal safety net is forced to support banks that falter because of disasters in those businesses. However safe these particular sectors of the securities business were thought to be in the past, they are seas of high risk today.

How much worse would it be if banks were in the most volatile and risk-filled parts of the securities business such as underwriting and trading junk bonds and equities? Indeed, we find it barely believable that Congress is considering allowing banks to underwrite and deal in corporate debt and equity under any conditions at this time. The securities business is not a guaranteed source of profit. It is highly cyclical. The 1970s produced waves of failures and thousands of layoffs. The mid-'80s appear to be repeating the pattern. October 19 was a warning; not all of the casualties are known yet, but one of our most distinguished names could not survive independently and had to merge. There may be more mergers and liquidations.

Congress has not seriously considered the problems associated with bank dealing in corporate debt and equities since 1933. Why should the taxpayer be taking on additional securities risks as capital markets grow increasingly unpredictable? What are the implications for bank control of American business? The conflicts of interest could be serious. Will tying and subtle pressures on borrowers increase? Are we about to repeat the cycles of the past? It was in 1927 that Congress blessed bank securities activities; just six years later, in 1933, that unfortunate experiment was terminated. By doing what the banks want, what will be gained? Consumers and businesses are not clamoring for banks to get into other businesses. The hue and cry is coming mostly from the banks themselves, their regulators and their friendly supporters.

Presently, the most successful banks in America appear to be the larger regionals which have by and large stuck to the business of banking. Certainly, they would like the ability to do other things, but our well-managed banks have been profitable and are extremely competitive in this country as well as internationally.

The top ranks of bank profitability charts feature American banks. Returns on equity for well-managed American banks are higher than for many of our best-known industrial firms. Our well-managed banks in the United States have better returns on equity than do the Japanese banks. Japanese banks have grown enormously, but so has the Japanese economy.

The savings rate in Japan, the increase in value of the yen, the trade surpluses flowing into Japan have all helped to make their banks huge. We believe that American banks can hold their own with the Japanese banks. We also should not lose sight of the fact that great size is not limited to banks in Japan. Just a few days ago Nomura Securities reported its profits for 1987: $4.3 billion. In fact, the top two Japanese securities firms had more profit in 1987 than the entire American securities industry earned in 1986, its best year in history.

If the bank arguments are analyzed one by one, they do not justify giving banks more powers in non-banking businesses so they can compete with others who do not have the special advantages that banks have. We have suggested in the past that those banks that very much want to be investment banks rather than commercial banks should give up the federal safety net and convert. Our industry does not fear fair competition. However, since the banks have been trying for so long to get into other businesses, some apparently feel something should be done for them, regardless of the merits of the arguments.

Banks that seek to participate fully in the securities business also want to be able to continue to use their unfair advantages. They euphemistically call these unfair advantages "synergy." "Synergy" is how banks will will take over the securities industry and any other non-banking business into which they gain unfettered entry.

We in the securities industry have watched with dismay but mostly in silence as banks operate in the securities business with their unfair advantages. Complaints are muted, because banks are formidable. Securities firms need their banks every day, every night. Securities firms are among the most significant borrowers from the nation's largest banks. One does not grumble too loudly.

We have thought long and hard about what to do. Just about everyone in the securities business agrees that banks have unfair advantages when they operate in the securities business, just as they have unfair advantages when they operate in other non-banking businesses. We do not believe that the one-sided entry of banks into our business would be good for the nation. the health of the securities industry or the free and open functioning of the capital markets. Despite bank charges about concentration in the securities industry, it is highly competitive as razor-thin pricing margins constantly prove.

The repeal of the Glass-Steagall Act as contemplated by the bills filed by Congressman Neal and in the Senate by Senators Proxmire and Garn is opposed strongly by SIA. These bills are one-way streets and grossly unfair. Banks would be allowed full entry into the securities business, but many of the firms in our industry, including all of those mentioned specifically earlier, would not be able to own a bank, even if they wanted to, because of affiliations they have which do not conform to the Bank Holding Company Act. The firms foreclosed from taking advantage of repeal of the Glass-Steagall Act are among the biggest in our industry and probably employ at least half the workforce our entire industry.

We do not mean to suggest the bills are entirely without virtue, however. They do at least recognize, albeit inadequately, the danger and unfairness of securities operations being carried on inside a bank, the impossibility of adequate regulatory oversight and the need to isolate at least some securities activities in a separate pocket closed off from affiliated banks by self-operative restrictions and prohibitions. Many in our industry have no desire to be banks or to be affiliated with banks. These firms would like to be able to exist as securities firms independent of banks and yet be able to compete effectively and profitably. They very much would like to keep the separation of banking from commerce intact, including whatever it takes to preserve effectively the principles of Glass-Steagall, the separation of securities firms from banks. Indeed, if the securities business were placed entirely off limits to banks, many would be pleased beyond measure. The problem that we have of course is that bank regulators, backed by the courts' deference to their regulatory roles, have opened up gaping holes in Glass-Steagall that Congress would have to repair.

There are also those in our industry who are coming to believe, along with some banks, that the problems of unfair combining of credit, tying, loss of objectivity and bank unfair advantage can be controlled through a new structure combined with tough firewalls preventing the utilization of bank advantages in other businesses. A good many in our industry, however, are not convinced that such firewalls can work. No one knows whether they can work; they have not been tried. Congress in 1933 must have considered the possibility and rejected it.

Therefore, we do have differing views within our industry on whether to go to a completely different structure or to reinforce the one we have. Arguments can be made both ways about what the globalization of markets means for letting everybody do everything. There are commentators, in London and elsewhere, who think the venture of British banks into the full range of securities activities is a big mistake with possible disastrous consequences. Japan, with a bigger market now than ours, seems to be in no rush to change its version of Glass-Steagall. Some feel that the loss of objectivity resulting from common ownership of a government-supported supplier of business credit and a securities firm--or any other financial or commercial firm--cannot be overcome and therefore should not be allowed. Some point to Glass-Steagall as the best "circuit breaker" one could have between the capital markets and banks as the heart of our financial system. Why do away with it when other circuit breakers are being sought for other kinds of potentially interconnected risks in our financial markets? Others say that we should try to see if there is some way to work out a balanced result that can preserve the best of what we have while making new combinations possible.

SIA has decided to attempt to reconcile these different points of view. Therefore, SIA is willing to move from its long held position to consider whether changes can be made in our structures that will accommodate the banks, accommodate those in our industry who are interested in being affiliated in some manner with banks and accommodate those who want to continue to compete in the securities business without the necessity of being affiliated with a bank to be competitive. We think it would be worthwhile to see the debate progress. We have an approach to suggest that is safe, sensible and fair.

The structure that appears to offer the most promise at the moment to test out the firewall approach is the bank holding company structure with modifications. How well the firewall will work is anyone's guess. Therefore, it should not be loaded with new risks before it is successfully tested. We in the securities industry are even willing to be guinea pigs for this restructuring experiment.

What we propose is relatively simple:

1. Isolate all existing securities-type activities of a bank and bank holding company family in one or more

direct subsidiaries of the bank holding company that engage only in such activities.

2. Erect the most effective firewall possible around all banks and thrifts in the bank holding company family so that they cannot with credit or otherwise directly or indirectly aid or support the operations of the securities affiliate and so that the unfair combining and tying of credit will be avoided. Routine cross-marketing could otherwise continue.

3. Provide for functional regulation for the securities affiliates: They should be supervised and the firewall provisions enforced by the regulators who oversee the operations of independent securities firms, with the SEC serving as principal overseer and ultimate arbiter. All of the registration, tax and accounting rules applicable to securities firms would apply to securities affiliates.

4. Make it clear that the federal safety net stops at the insured accounts or at the most the insured banks and thrifts in the holding company, so that government backing provides no advantages for the securities affiliates and taxpayer support is removed from securities operations.

5. Prohibit discrimination by all units of bank holding companies with securities affiliates against securities firms that lack banking affiliations. Such banking organizations should be precluded from discriminating in the availability and terms and conditions of credit between independent securities firms and securities affiliates of other banks. Similarly, such banking organizations should be prohibited from discriminating against independent securities firms with regard to access to and charges for use of the payment system mechanism.

6. While the experiment is being conducted and the operation of the firewall monitored to see if such a firewall can take the place of separate ownership of banking and commercial units, Congress should keep full control. Bank regulators should not have the ability to tinker with the structure to relax restrictions, to eliminate prohibitions or to give other securities powers, insurance powers or real estate powers to their supplicant banks.

7. Continue the examination of the policy, risk, conflicts and other questions involved in dismantling the walls between banking and commerce while assessing the operation of the new bank holding company structure and the firewall through good times and bad,

> calm times and times of emergency. The need for additional coordination of oversight and regulation of financial systems nationally and internationally should also be examined. Recognizing the complexity of the problem and the need for expertise as well as policy guidance, we suggest a joint committee of Congress or a commission involving relevant committees of Congress, the various regulators, experts and industry and consumer interests. There should be a fixed but adequate time--such as two years--for recommendations to be filed with Congress.

If the new structure with the firewall works and the other questions are answered satisfactorily, then a new day can dawn for all in which banks can be affiliated with other financial and commercial firms and yet those firms which choose not to so affiliate can continue to survive, compete effectively and prosper. In addition, a way will have been found to keep the federal safety net confined to the protection of essential banking functions.

Accomplishing this result will not be easy, but it should be possible.

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